Staff analytical paper / Document analytique du personnel—2026-29

Last updated: June 11, 2026

# The investor base for sovereign debt: Why diversification matters

Sam Foxall
Public Debt Management & Financial Markets
OECD
sam.foxall@oecd.org

Jeffrey Gao
Markets and Banking Department
Bank of Canada
jgao@bankofcanada.ca



DOI: https://doi.org/10.34989/sap-2026-29 | ISSN 3110-9195

# Abstract

Sovereign borrowing is rising, just as central banks are stepping back. Meanwhile, commercial bank holdings of sovereign bonds remain well below pre-global financial crisis levels. This leaves foreign investors and investment funds, often hedge funds, to absorb more of this growing supply. Their greater involvement supports liquidity and robust auction results, but it can also concentrate risk: in stressed markets, correlated deleveraging and fast outflows can translate volatility into higher funding costs, reinforcing the case for investor base diversification.



*Topics: Debt management ; Financial institutions ; Financial markets*

*JEL codes: G18, G28, H63*

## In volatile markets, a diverse investor base is critical to help ensure issuance is smoothly absorbed

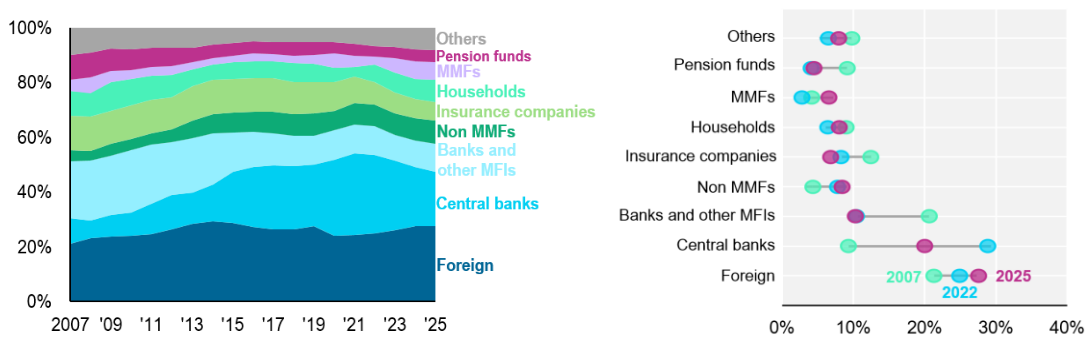
Jumps in short-term government bond yields in early 2026 have increased borrowing costs for sovereign debt managers. This largely reflects shifting expectations about inflation and monetary policy following spikes in energy prices.[1] However, the resulting volatility has also revived concerns that the growing role of certain investor groups may be amplifying price swings.

Against this backdrop, sovereign issuers must remain mindful of who is active in their markets. An investor base that is overly concentrated in more price-sensitive and leveraged investors increases the risk that volatility could weaken auction demand or trigger divestments.

## New marginal buyers have stepped in to take down additional supply

While excessive concentration of the investor base is not currently a major risk across OECD countries, three key trends identified in the OECD Global Debt Report 2026 (OECD 2026) since 2007 have made it more relevant (Figure 1).

### Figure 1: Since 2022, the marginal buyers of sovereign debt have shifted from central banks to foreign investors and investment funds (Money Market Funds (MMFs) and non-MMFs)



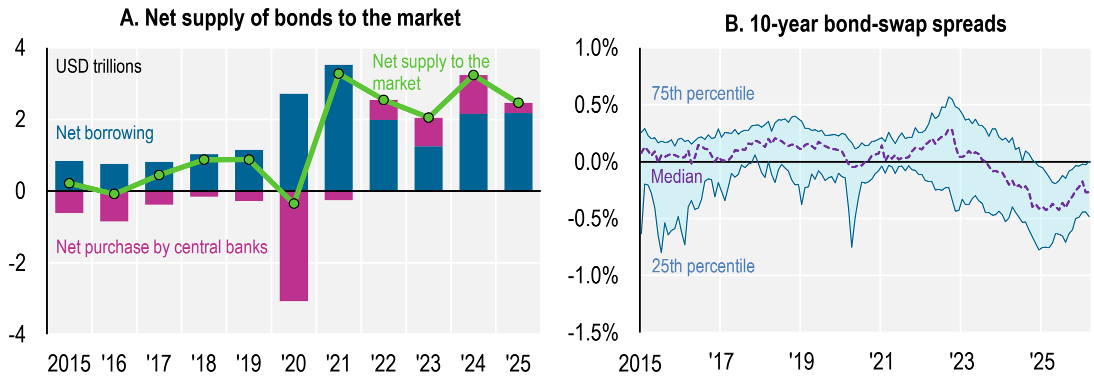

Note: Data covers the euro area, Japan, and the United States general govt. Values as of Q2 2025 for the Euro area and Q3 2025 for the United States and Japan. Intra-Euro area holdings are considered domestic. Data on Euro area governments are available from 2013. For the United States, households' holdings of government bonds have been adjusted for estimated foreign hedge fund holdings.
Marginal buyers are the threshold buyers that set the market-clearing price.
Source: OECD Global Debt Report 2026

[1] In recent months, futures markets in some OECD countries have shifted from pricing in rate cuts in 2026 to pricing in rate hikes.

First, *central banks entered as large net buyers through quantitative easing, especially in response to the global financial crisis (GFC), euro area crisis, and COVID-19 pandemic, but began unwinding these programs starting in 2022.*[2] This unwinding, combined with elevated sovereign debt issuance since the pandemic, has led to a sharp increase in net supply post-2022 (Figure 2, Panel A) and a deterioration of the supply-demand balance.[3] This is likely to worsen as the conflict in the Middle East can potentially drive up interest costs and as governments finance fiscal packages to offset the impacts of higher energy costs on populations.

Second, *banks and other monetary financial institutions (MFIs) became net sellers as post-GFC banking regulations raised the cost of warehousing bonds for intermediation*. As a result, banks have been less able to absorb this higher net supply, with bond yields rising relative to swap rates, as reflected in more strongly negative swap spreads (Figure 2, Panel B).

### Figure 2: Post-2022 supply-demand pressure has led 10-year swap spreads to turn negative




Notes: The swap spread is the difference between the rates on an off-balance sheet interest rate swap versus a same-term sovereign bond. Thus, a negative swap spread tends to indicate that investors demand higher compensation for holding the sovereign bond on balance sheets. Aquilina et al (2024) discuss some of these factors.
Source: OECD Global Debt Report 2026

Third, despite lower bank holdings since the GFC and lower central bank holdings since 2022, bond auctions across major OECD issuers have continued to be well supported (Figure 3) as *foreign investors and investment funds—many of which are hedge funds—have responded to more supply by increasing their holdings*. This has been important for issuers, as it has ensured strong demand for supply events and helped to mitigate the increase in their funding costs.

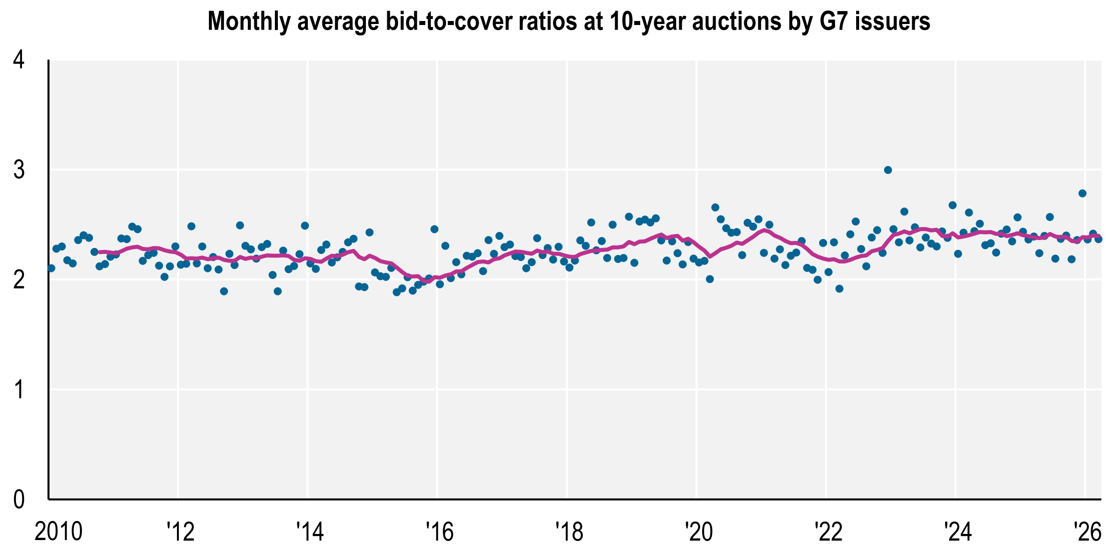
---

[2] Partly because the earlier stimulus was no longer needed, and partly to combat higher inflation.

[3] Net supply refers to net government borrowing (gross borrowing less maturities) minus net purchases by central banks.

In 2025, hedge funds were marginal buyers in over half of OECD countries. In the United States, greater auction absorption by non-dealers has eased dealer intermediation burdens and kept price pressures steady (Fleming, Liu, and Nguyen 2026). In Canada, hedge fund auction allocations have gone from effectively zero to 40-50% in the last fifteen years, as more debt issuance has made their business models—which depend on scaling up relative value strategies—more viable (Epp and Gao 2025).

**Figure 3: Despite higher net supply, bond auctions by major OECD issuers continue to be comfortably oversubscribed with robust bid-to-cover ratios**




Note: Each data point marks a monthly average, the line refers to a moving average across 10 data points.
Source: OECD Global Debt Report 2026

## These marginal buyers also support secondary market liquidity

The positive impact of hedge fund participation also extends to secondary market liquidity. As bond-warehousing costs have risen for traditional bank market-makers, hedge funds have taken on a larger role in liquidity provision. This liquidity helps sovereigns borrow regularly at scale at near-market prices and allows other participants to transfer risk with limited price impact.

In 2025, almost a quarter of OECD sovereigns reported that hedge funds played a warehousing role in their bond markets. Hedge funds also accounted for more than half of electronic trading in European government bonds on Tradeweb, up from about a quarter in 2018 (ECB 2025). Their relative value trading can also help smooth out price dislocations across the curve, improving price alignment and fair-value signals.[4] They are reportedly playing this role in nearly two-thirds of OECD sovereign bond markets.

## But concentration risks can also rise when the marginal buyers are too similar

However, the newly critical role of this investor type does create risks of over-reliance, especially in more volatile market conditions. While hedge funds can employ different strategies that lead to distinct behaviors, some commonalities in their strategies and properties can amplify volatility. In the case of a large shock, hedge funds may exit more quickly and in larger volumes from a sovereign's bond market than domestic dealers and financial intermediaries; this can be due to higher use of leverage, shorter holding periods, less organic commitment to one particular sovereign market, and/or riskier business models leading to attrition. This could abruptly raise government funding costs. Hedge funds' high leverage can also amplify price moves, and in a crisis, they may contribute to sudden unwinds, weighing on market liquidity (Sandhu and Vala 2023).

This post-2022 shift towards a greater reliance on hedge funds and foreign investors is a current manifestation of a broader theme. *When a sovereign bond market is growing and/or other investor types are retreating, marginal investors are critical—but they also pose risks if they are too concentrated in one type (or types) with correlated behaviour*. This correlation can take many forms (Figure 4), each with its own consequences.

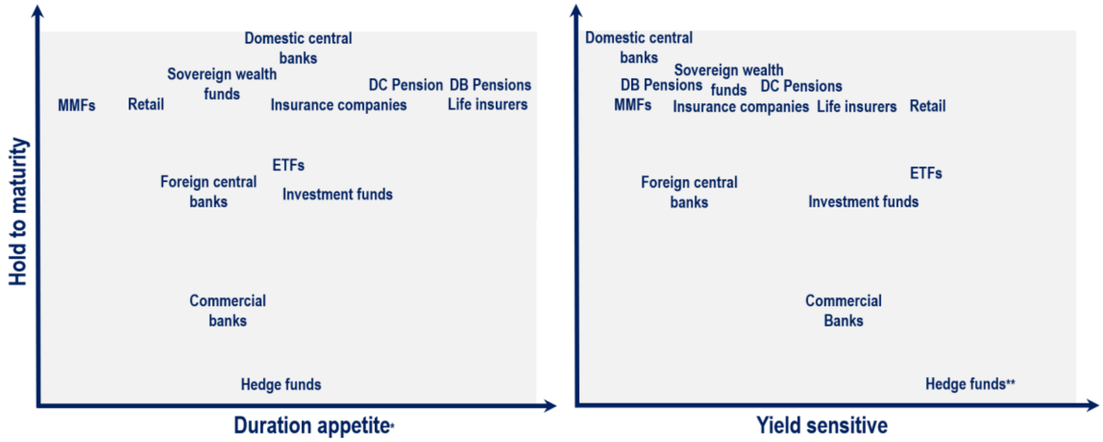
An investor base skewed to short- or long-duration preferences can compromise the issuer's ability to maintain a balanced program of issuance.[5] Too many price-sensitive or short-horizon investors can leave the market vulnerable to sudden price spikes and mass selloffs. At the same time, too many price-insensitive, hold-to-maturity investors can lead to scarcity and illiquidity.

---

[4] The fair value of a bond is the present value of all the cash flows it will pay, discounted at the appropriate market interest rate.

[5] Specifically, maintaining a sufficiently liquid yield curve across all tenors as well as balancing the higher refinancing risk of short-term debt with the typically higher cost of long-term debt.

**Figure 4: Investor types vary by holding period, duration appetite and yield sensitivity: A robust sovereign investor base should have a healthy mix**




Notes: This figure represents a general illustration of the characteristics of different investor types. Actual characteristics will be determined by organizations' individual trading strategies and wider market and demand conditions. * Duration appetite here refers to the average duration appetite. Certain entities, such as domestic central banks and hedge funds, trade and/or hold debt instruments right across the duration curve. ** Hedge funds are more sensitive to relative rather than outright yield levels; they typically trade price dislocations on the curve, around supply events, between markets, and between cash bonds and derivatives.
Source: OECD Global Debt Report 2026

## Issuers must be proactive and deal with market and demand conditions, as they are, not as they might wish them to be

While a sovereign issuer can mitigate these risks by better understanding the behaviour of its marginal investors, it should also make continued efforts to incentivize new and different investors to enter its market. For example, by bringing in new dealers of different types, revisiting auction rules, introducing measures to attract more retail investors, engaging in more active investor relations, or showing greater flexibility as to the maturities/bonds it offers.[6]

With sovereign debt issuance rising to record levels globally, maintaining an investor base with diverse properties and behaviors is more important than ever to support debt managers' objectives of stable, low-cost issuance. Further, as heightened volatility causes some investors to pull back and any de-anchoring of inflation expectations could further reduce demand for duration, continually attracting new types of investors will be crucial. This will provide a robust backstop for demand and mitigate volatility through a balanced mix of positions and flows among market participants. Without a major change

[6] In 2025, Canada adjusted its Debt Distribution Framework through all three levers—most notably, a reform of its intermediate dealer class to incentivize new foreign entrants—with an objective of enhancing and diversifying its investor base given rapidly rising debt issuance.

in countries' fiscal positions, monetary policy, or regulation, this need for investor base diversification is only likely to grow.

# References

Aquilina, M., A. Schrimpf, V. Sushko, and D. Xia. 2024. "Negative Interest Rate Swap Spreads Signal Pressure in Government Debt Absorption." BIS Quarterly Review. Bank for International Settlements, December 10.

Epp, A. and J. Gao. 2025. Are Hedge Funds a Hedge for Increasing Government Debt Issuance? Bank of Canada Staff Discussion Paper No. 2025-7 (May 2025).

European Central Bank. 2025. Hedge Fund activity in Bond, Repo and Futures Markets: Unpacking the Data. Bond Market Contact Group. 26 November 2025.

Fleming, M., W. Liu, and G. Nguyen. 2026. Intraday Price Pressure and Order Flow Around U.S. Treasury Auctions, Federal Reserve Bank of New York Staff Reports, No. 1188 (March 2026).

OECD. 2026. Global Debt Report 2026: Sustaining Debt Market Resilience Under Growing Pressure, OECD Publishing, Paris.

Sandhu, J. and R. Vala. 2023. Do hedge funds support liquidity in the Government of Canada bond market? Bank of Canada Staff Analytical Note No. 2023-11.