

Hedge funds and bond market liquidity dynamics at the onset of the 2026 Middle East conflict

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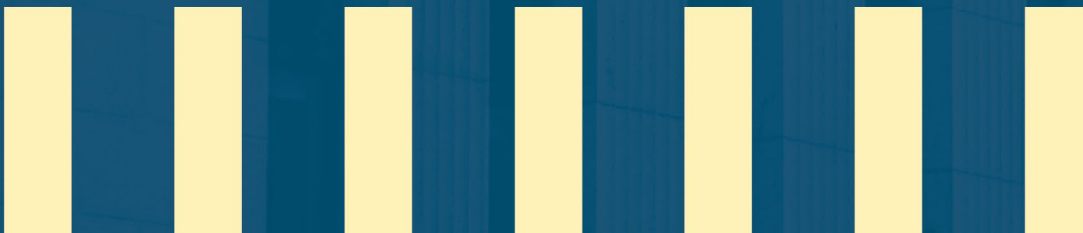
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Abstract

We examine whether hedge funds and other asset managers contributed to illiquidity in the Government of Canada bond market at the onset of the war in the Middle East in early 2026. We find no evidence that they did. Hedge funds remained active participants in primary auctions, while the extent to which dealers could offset client transactions in secondary markets stayed within its typical range. Although hedge funds did reduce leveraged positions, their trading remained broadly consistent with their usual relative-value strategies.

Topics: Financial institutions and intermediation; Financial markets and funds management; Financial stability; Financial Stability and systemic risk; Market functioning

JEL Codes: G0, G01, G12, G14, G23, G24

Introduction

Past episodes of market turmoil have raised concerns that leveraged investors can rapidly unwind positions and contribute to illiquidity in sovereign bond markets. During the COVID-19 crisis, for example, stress in the U.S. Treasury market coincided with hedge fund deleveraging in the cash-futures basis trade ([Barth and Kahn, 2021](#)). Similarly, during the 2022 UK gilt crisis, liability-driven investment funds unwound leveraged positions following margin calls ([Cunliffe, 2022](#)).

The onset of the war in the Middle East in early 2026 provides an opportunity to examine whether similar dynamics emerged in the Government of Canada (GoC) bond market during this episode of market stress, building on past Bank of Canada analysis studying hedge fund activity around the COVID-19 crisis ([Sandhu and Vala, 2023](#)). At the onset of the war, volatility increased across global financial markets, and sovereign bond yields rose sharply in several jurisdictions. Reports also pointed to large losses among hedge funds pursuing macro and term-structure strategies in sovereign bond markets as the repricing unfolded ([Tetley and Kumar, 2026](#)). In the United Kingdom, hedge fund deleveraging was also found to have amplified movements in gilt yields ([Bank of England, 2026](#)). In Canada, liquidity in the GoC bond market deteriorated temporarily, suggesting that similar dynamics could have occurred in Canadian markets.

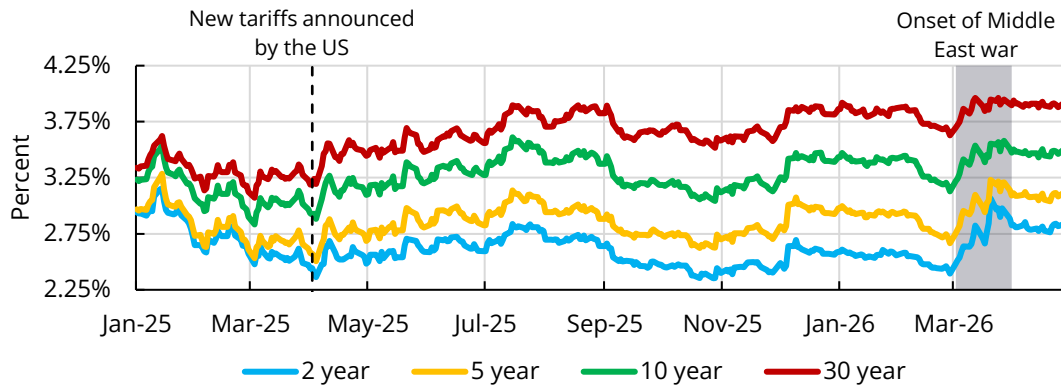
We find no evidence that hedge funds or other asset managers amplified illiquidity in the GoC bond market at the onset of the war. In the primary market, hedge funds continued to purchase a large share of newly issued GoC bonds, consistent with their usual behaviour. In the secondary market, the share of transactions that dealers could offset between their clients remained within its typical range. Together, these findings suggest that dealers did not have to absorb an unusually large volume of GoC bonds onto their balance sheets, helping to limit any material increase in their costs of intermediation and the associated effects on market liquidity. These offsetting client flows reflected hedge funds as net sellers and other asset managers, including pension funds and wealth managers, as net buyers, consistent with hedge funds' typical role of transacting GoC bonds in the opposite direction to other asset managers. It is also consistent with the relative-value strategies hedge funds typically pursue across primary and secondary markets, as suggested by their purchases in the primary market alongside sales in the secondary market during this period.

Government bond yields rose sharply at the onset of the war

We define the onset of the war as the period from its start on February 28th to the end of March 2026, when volatility remained elevated. This period was associated with a rapid increase in GoC bond yields (**Chart 1**), amid a broad repricing of inflation risks and term premia. The move was most pronounced at the front end of the yield curve, with 2-year yields rising by almost 70 basis points before declining slightly. Yields across longer maturities also increased materially over the period.

Chart 1: Canadian government bond yields rose sharply at the onset of the war

(Canadian sovereign bond yields)



Note: The shaded area represents the business days between the start of the war on February 28 and the end of March.

Sources: Refinitiv Workspace and Bank of Canada calculations

Last observation: April 30, 2026

Liquidity conditions also deteriorated temporarily over this period. The deterioration was considerably less severe than during the COVID-19 crisis, consistent with lower level of bond market volatility compared with March 2020.¹ Feedback from market participants also suggested that, aside from brief periods of increased illiquidity at the onset of the war, trading conditions generally remained orderly throughout the episode.

This episode, characterized by a temporary deterioration in liquidity but continued market functioning, provides a useful setting to assess the trading behaviour of leveraged investors, such as hedge funds, in the GoC bond market during a period of moderate stress.

Hedge funds continued to purchase a large share of government bonds at primary auctions

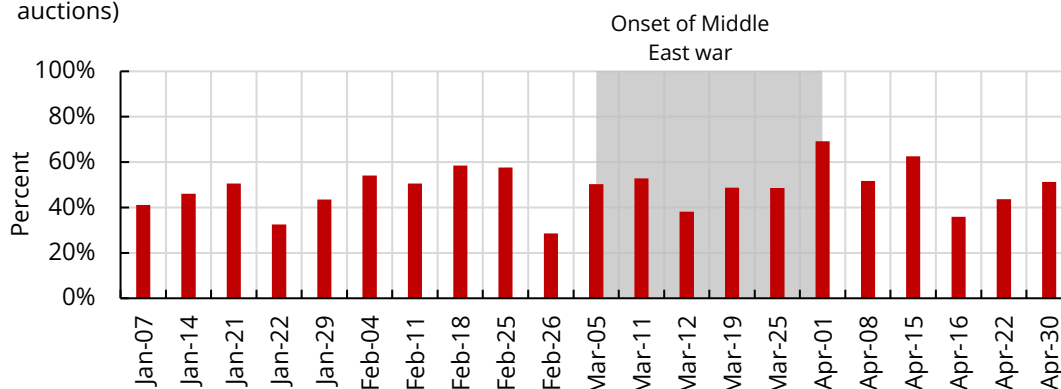
In this section, we examine whether there was any change in hedge funds' participation in the primary market for GoC bonds at the onset of the war. Given hedge funds are large participants in GoC bond auctions, a reduction in their participation during this period of market stress could have resulted in dealers having to purchase a larger share of newly issued bonds. This could have increased dealer inventories and the costs of managing these positions, including through hedging in derivatives markets such as futures. This could have reduced liquidity in secondary markets, since dealers may pass on these higher costs to their clients, for instance, through wider bid-ask spreads ([Kocourek and Walton, 2026](#)).

¹ Series of a broad set of market liquidity measures are available on the Bank of Canada's webpage for [Financial Stability Indicators](#).

We find no change in hedge fund participation at primary auctions during this period. Hedge funds continued to purchase around 40 to 50 percent of newly issued bonds (**Chart 2**), consistent with their typical behaviour ([Epp and Gao, 2025](#)). This suggests that dealers did not need to absorb an unusually large share of newly issued GoC bonds on their balance sheets.

Chart 2: Hedge funds continued purchasing a large share of government bonds in the primary market

(Share of newly issued Government of Canada bonds purchased by hedge funds at primary auctions)



Note: The shaded area represents the business days between the start of the war on February 28 and the end of March.

Sources: Department of Finance Canada and Bank of Canada calculations

Last observation: April 30, 2026

The extent to which dealers could offset secondary market transactions across their clients remained stable

In this section, we examine the extent to which dealers could offset their clients' GoC bond transactions with each other in the secondary market. Similar to the primary market dynamics discussed earlier, when asset manager flows become predominantly one-sided, dealers may need to absorb the imbalance onto their balance sheets, which can increase inventory management costs. By contrast, balanced buying and selling across asset managers allows dealers to offset client trades more readily, limiting unwanted inventory accumulation and supporting liquidity.

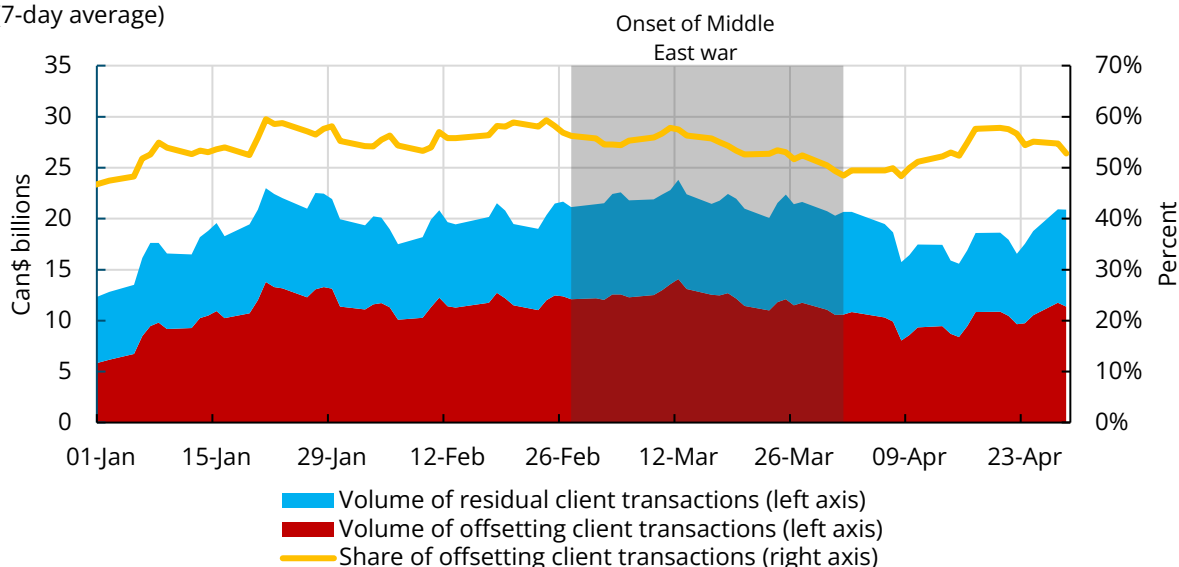
To assess this, we measure the extent to which client transactions offset each other within individual GoC bonds on each trading day.² Our measure shows that offsetting activity remained within its typical range of roughly 50 to 60 percent of total client transactions during the onset of the war (**Chart 3**). Correspondingly, the volume of residual client trades—those that dealers could not offset across clients and therefore had to absorb onto their own balance sheets—also remained broadly stable. This suggests that, as in the

² See [Sandhu and Vala \(2024\)](#) for details on our methodology.

primary market, dealers did not have to absorb an unusual volume of GoC bonds onto their balance sheets in the secondary market.

Chart 3: The extent of two-sided client flows to dealers was stable at the onset of the war

(7-day average)



Note: Higher residual amounts suggest higher transaction volumes for dealers to intermediate using their own balance sheets, rather than offsetting the transaction across their different clients. The shaded area represents the business days between the start of the war on February 28 and the end of March.

Sources: Market Trade Reporting System and Bank of Canada calculations

Last observation: April 30, 2020

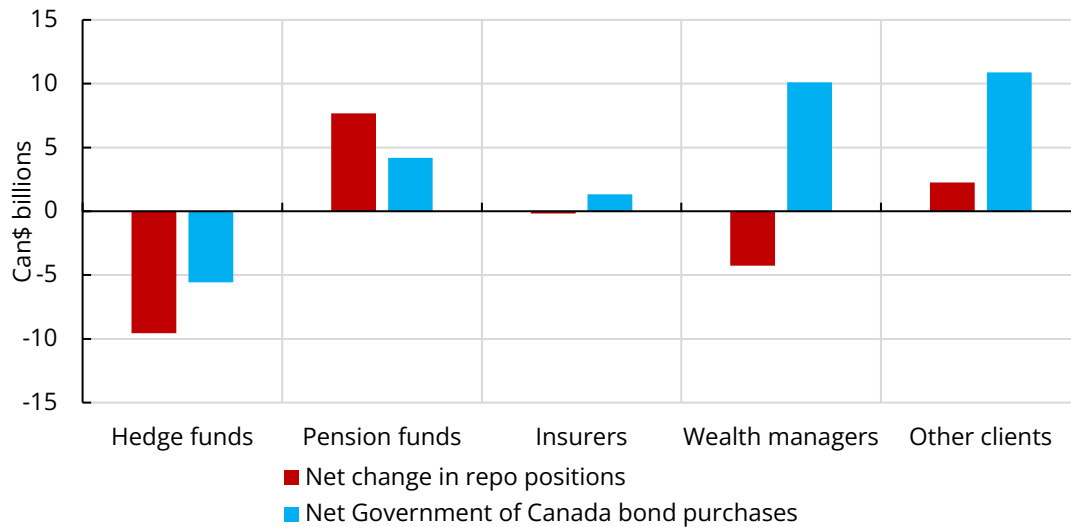
Hedge fund trading activity was consistent with their usual relative-value strategies, supporting two-sided market flows

In this section, we examine the composition of asset manager flows in the secondary market to better understand the sources of the offsetting client flows discussed in the previous section and the role hedge funds played during the episode.

We find that hedge funds reduced repo borrowing and were net sellers of GoC bonds in secondary markets during the episode, consistent with a reduction in leveraged positions (**Chart 4**). This deleveraging was sizeable relative to historical levels, with the decline in net repo borrowing ranking as the largest monthly decline and net sales ranking as the second largest monthly net selling since January 2020. In contrast, other asset managers, including pension funds and wealth managers, were net buyers of GoC bonds. Some pension funds also increased their net repo borrowing, suggesting that repo financing supported their purchases.

Chart 4: While hedge funds reduced their repo positions and sold government bonds at the onset of the war, some other asset managers transacted in the opposite direction

(Net change between February 28 and March 31)



Note: *Others clients* includes other clients of dealers, such as foreign central banks and sub-sovereigns.

Source: Market Trade Reporting System and Bank of Canada calculations

Last observation: March 31, 2026

Our analysis suggests that hedge funds' deleveraging during this episode was not disorderly and was consistent with their usual role. Their selling while others were buying, is consistent with hedge funds' typical trading behaviour in GoC bond markets. Past analysis and market intelligence discussions suggest that as relatively flexible investors, hedge funds may be well placed to accommodate others' demand for GoC bonds, by transacting in the opposite direction of other asset managers when profitable ([Sandhu and Vala, 2023](#)). The resulting two-sided trading flows can support market liquidity. In addition, if hedge funds had been forced to unwind their leveraged positions, potentially in a disorderly way, their transactions would likely have been associated with higher execution costs. However, we find no material change in hedge funds' cost of immediacy, measured as the price of their trades relative to the interdealer mid-price.³ Moreover, hedge funds' continued participation in primary auctions alongside their sales in secondary markets is consistent with the relative-value strategies they typically pursue across these markets ([Uthemann and Walton, 2026](#)). These strategies seek to profit from small price differences between newly issued and existing bonds with similar maturities and can facilitate the transfer of bonds between primary and secondary markets, including to asset managers that are less active in the primary market.

³ Our measure of immediacy cost is the side-adjusted difference between the yield at which hedge funds transact and the mid-yield of interdealer trades, computed at the bond level in two-hour intervals and aggregated to daily frequency using volume weights. We find no statistically significant difference in this measure across the onset of the war, the preceding months and the subsequent period.

Conclusion

We find no evidence that hedge funds amplified illiquidity in the GoC bond market at the onset of the 2026 war in the Middle East. Hedge funds continued to participate actively in primary auctions, while dealers were able to offset a typical share of client transactions in secondary markets, limiting the need to absorb high volumes of bonds onto their balance sheets. Although hedge funds appear to have reduced leveraged GoC bond positions, the broader evidence suggests that their trading remained consistent with their usual behaviour, including relative-value trading across primary and secondary markets that facilitated two-sided flows in the secondary market.

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