Working Paper

Beyond Basis Basics: Leverage Demand and Deviations from the Law of One Price

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Deviations from the law of one price between futures and spot prices, known as bases, reflect the difference between interest rates implied in futures prices and benchmark borrowing rates. These differences are driven by intermediaries' cost of capital and the amount of leverage demand for an asset. Focusing on leverage demand, we find that bases negatively predict futures and spot market returns with the same sign in both global equities and currencies. This evidence is consistent with bases capturing uninformed leverage demand. We investigate the source of this demand in both markets using dealer and institutional positions data, securities lending fees, and foreign capital flows and find that the return predictability represents compensation to intermediaries for meeting liquidity and hedging demand. Our results have broader implications for understanding the interest rates embedded in derivatives prices.