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IS U.S. TREASURIES' STATUS AS A FLIGHT-TO-QUALITY ASSET UNDER THREAT?

KEY POINTS

- U.S. Treasuries have traditionally been regarded as the ultimate "flight to quality" asset, but it is unclear whether they will continue to be so in future.
- One of the reasons for this is that Treasury issuance is threatening to outstrip demand—the fewer buyers there are, the riskier an asset becomes.
- In recent years, Treasuries have also become positively correlated with equities during times of market stress—undermining their ability to function as a defensive anchor during difficult periods.
- There are no clear candidates to replace Treasuries if they cease to be the flight-to-quality asset of choice for investors.

U.S. Treasuries have traditionally been the ultimate "flight to quality" asset, regarded by governments, institutions, and individual investors as a haven during periods of volatility and uncertainty. This may be changing, though. Shifting supply/demand dynamics, a breakdown in traditional correlation patterns, and even concerns over the U.S. government's creditworthiness have raised doubts over whether Treasuries will continue to function as the defensive portfolio anchor of choice.

This could have profound implications for portfolio construction. Flight-to-quality assets only work when backed by crowd behavior: The less investors buy them, the riskier they become. If, in the future, investors cease to regard Treasuries as the ultimate flight-to-quality asset, what will replace them? Will any assets be considered low risk enough to function as a haven in times of stress? If not, what combination of investments will provide portfolios with the most effective anchor during difficult periods? These will be vital questions to answer for any investor seeking to plot an effective path through future economic cycles.

TREASURY ISSUANCE THREATENS TO OUTSTRIP DEMAND

In a speech in April 2001, then Federal Reserve Chairman Alan Greenspan spoke of a future in which fiscal surpluses "will allow the Treasury debt held by the public to be paid off"—in other words, a future in which Treasuries would cease to exist. There is no sign of this happening any time soon. U.S. debt issuance has exploded in recent years and is forecast to continue rising to help finance a budget gap that is widening on the back of President Trump's tax cuts and spending increases. The U.S. Treasury Department recently predicted that the U.S. will issue USD $769 billion worth of debt in the second half of this year—the highest since USD $1.1 trillion in July–December 2008.

Is there sufficient demand to mop up all this issuance? It's not yet clear. The Fed has been the biggest buyer of Treasuries in recent years through its quantitative easing program, more than quadrupling its balance sheet to USD $4.5 trillion in the process. However, these purchases have come to an end as the Fed has thrown its stimulus program into reverse and is now seeking to reduce its balance sheet to something approaching a normal size.

Foreign institutional investors, the next biggest buyers of U.S. government debt, are also expected to reduce their demand for Treasuries over the next few years (see Figure 1). This is partly because higher U.S. front-end rates have resulted in prohibitive hedging costs for foreign investors, severely reducing the available net returns from Treasuries. Ongoing tensions over President Trump's trade policies are also a factor. In March, China's ambassador to the U.S. refused to rule out the possibility that his country—the biggest foreign buyer of U.S. debt—would scale back its purchases of Treasuries in response to tariffs imposed by the U.S. Then, between March and May, Russia sold off most of its U.S. debt holdings in retaliation to the U.S.'s decision to impose strict sanctions against Moscow. If tensions over trade between the U.S. and other countries continue, foreign demand for Treasuries could fall further.

Reduced demand from the Fed and foreign central banks will result in a greater need for domestic buyers to purchase Treasuries. U.S. corporate pension funds have been allocating heavily to Treasuries this year, driven by tax legislation designed to encourage them to increase allocations to long maturity bonds—however, this incentive was due to come to an end on September 15, after which pension funds' Treasury purchases are expected to drop off. This leaves asset managers, hedge funds, and households, which may be persuaded to ramp up their purchases of U.S. government debt to a certain extent, but only if yields rise enough to make it worth their while—and, even then, demand from this section of the market is unlikely to make up for a significant fall in Treasury purchases from the Fed and major foreign buyers.

ARE CORRELATIONS AT A TURNING POINT?

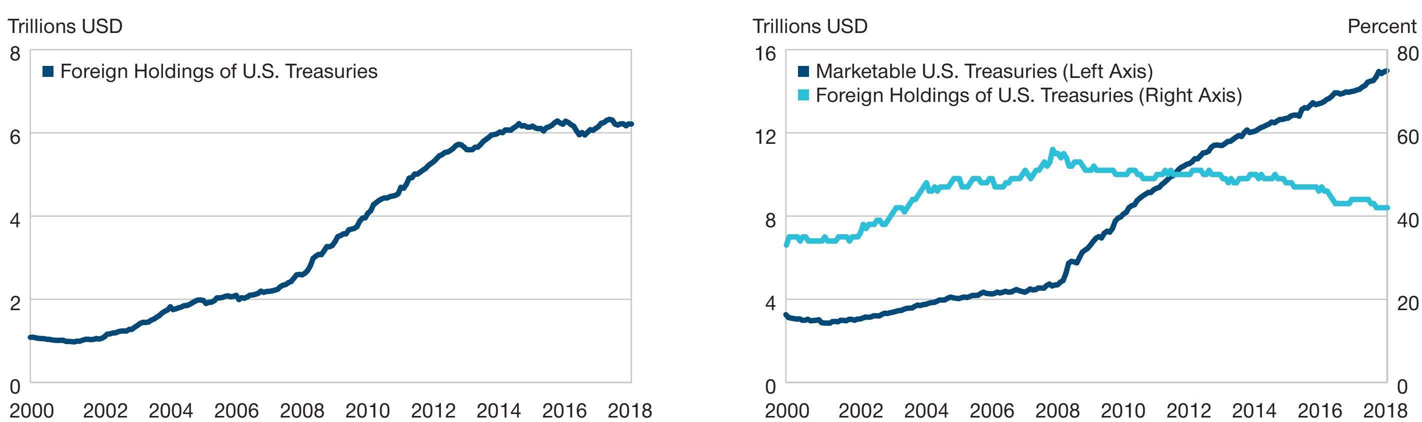
Another potential threat to Treasuries' safe-haven status is a change in their relationship with equities. Since the late 1990s, Treasuries have generally been negatively correlated with equities—i.e., they have tended to move in opposite directions. This has meant that, during periods of equity market stress, Treasuries have usually performed well, providing investors with a vital defensive anchor. Recently, however, there have been signs that this pattern is breaking down (see Figure 2). During the volatility spike earlier this year, for example, the S&P 500 Index fell 10.2% from January 26 to February 8—but 10-year Treasuries fell 1.5% over the same period. This positive correlation persisted for the first quarter as a whole before becoming negative again in the second quarter.

During the previous major VIX spike in August 2015, which occurred on the back of the Chinese market correction shock, stocks and bonds were positively correlated. The same occurred during the "taper tantrum"' of 2013, the euro sovereign crisis of 2010, and the dollar correction in 2005/2006.

One explanation for the positive correlation in the first quarter of this year is that concerns over a potential trade war between the U.S. and other countries fueled the perception that Treasuries have become less safe, making them less attractive at a time when they would usually benefit from a flight to quality.

FIGURE 1: **Foreign Holdings of U.S. Debt and U.S. Debt Outstanding**

As of June 2018



Source: U.S. Treasury.

This is a contentious issue: Treasuries are considered to be virtually risk-free because the U.S. government's ability and willingness to pay its debts have never been seriously questioned. However, Donald Trump's unconventional presidential style, typified by his controversial and frequently antagonistic tweets, may begin to raise mild concerns about the creditworthiness of the U.S. government. President Trump's self-confessed cavalier attitude to debt while building his business empire will also probably not help in this regard.

Whatever the cause, if this is the beginning of a trend and Treasuries and equities become more positively correlated in future volatile periods, the diversification benefits of holding Treasuries will erode, making them much riskier assets to hold in a portfolio.

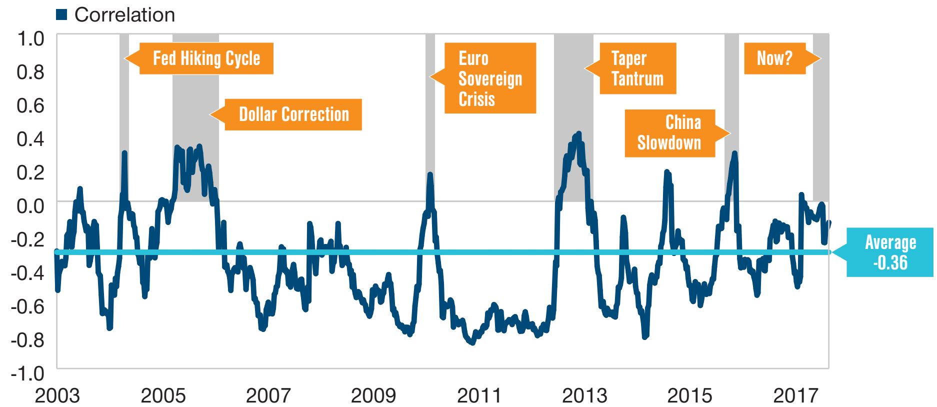
INVESTOR PSYCHOLOGY MEANS OLD HABITS WILL BE HARD TO BREAK

The developments described above are long term in nature. Investor psychology is a very powerful force, and the belief that U.S. government debt is the safest available asset is likely to remain strong for some time. As such, if the next downturn occurs as expected in the next few years, it is likely that Treasuries will again fulfill their traditional role as a safe-haven asset. However, investors planning further ahead may benefit from reexamining the role that Treasuries play in their portfolios and asking themselves whether they will continue to work as effectively in the future.

FIGURE 2: Historic Correlation: U.S. Equities vs. U.S. Government Bonds

Six-Month Moving Average, Based on Weekly Performance

December 2003 Through June 2018



Sources: S&P and Bloomberg Barclays. Analysis by T. Rowe Price.

If Treasuries cease to be regarded as the ultimate flight-to-quality asset, what could take their place? German bunds are one possibility, but the fact that they are denominated in euros—whose long-term sustainability is questioned by some investors—counts against them. Over the longer term, Chinese government bonds are another contender, but major questions remain about their liquidity and accessibility, and also about the creditworthiness of the Chinese government. It is therefore possible that, in the future, no country's sovereign bonds will be considered completely risk-free, and investors will be forced instead to decide which of a number of competing assets—or which combination of different assets—forms the "lowest risk" element of their portfolio. As yet, there are no clear answers to these questions—however, given the vital importance of finding anchors during times of stress, it may be worth asking them sooner rather than later.

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