T. Rowe Price

Where can investors find defensive assets in today's evolving markets?

From the Field

Key Insights

- Unlike during the period between the global financial crisis (GFC) and the pandemic, inflation is now an important risk.
- The U.S. dollar is one of the few asset classes or currencies that have been consistently defensive through the post-GFC and post-COVID periods.
- Cash is a defensive asset class that has become much more attractive because yields have risen markedly from the zero interest rate pandemic environment.

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Which asset classes provide the best defense against a downturn in risk assets? The answer has evolved as market and economic conditions have changed over the years. We recently discussed this vital portfolio construction question with three T. Rowe Price experts: Arif Husain, Sébastien Page, and Adam Marden. Their answers illustrate the diversity of thought within T. Rowe Price, where collaboration between investment professionals with different views is a hallmark of our investment process. They agree that the U.S. dollar remains a defensive stalwart and discuss the merits of other assets, including long-maturity U.S. Treasuries, cash, and value stocks.

What asset classes have held their own as defensive stalwarts over the years?

Adam: First, it's important to frame why defensive asset classes are changing. From 2008 to 2020, managing downside risk in portfolios was managing the downside of growth rather than the upside in inflation. Today, we have several directions of risk, including high inflation, stagflation, and low growth.

At the end of the day, for growth risks, short-maturity U.S. Treasuries are the best diversifier for a portfolio with equities as well as high yield bonds or bank loans. In an inflationary environment, however, there is still downside risk to holding short-term

Treasury debt because it has some duration.[1] But short Treasuries now provide decent yield to compensate for that risk.

Arif: The U.S. dollar is still, in my view, the market's "safe-haven" currency. That hasn't changed over the years.

Sébastien: The U.S. dollar was one of the only assets that performed well in 2022, proving its value as an inflation hedge. Like Adam said, in the current environment with a greater variety of risks, an asset that will perform well no matter what is driving a risk asset sell-off is an ideal diversifier.

Adam: It's important to note that the dollar's consistently defensive performance has been during a U.S. exceptionalism time period. If that narrative flips, the U.S. dollar's defensive characteristics could erode quickly as investor demand for other currencies grows.

How about long-maturity U.S. Treasuries, which formed the fixed income backbone of the traditional 60/40 stocks/bonds asset allocation?

Sébastien: I believe long duration U.S. Treasuries are still an excellent hedge against the risk that a recession drags down equities and credit risk. But as we saw in 2022 when the Federal Reserve aggressively raised interest rates to fight inflation, the asset class doesn't work as a diversifier in an inflation-driven risk sell-off.

Arif: Long-maturity Treasuries have also become much more volatile, taking away some of their diversification advantages. At the height of the rush to safe-haven assets at the onset of the pandemic in 2020, long-maturity Treasury yields actually increased sharply during some of the most severe selling in stocks.

It took the Fed's intervention in mid-March 2020—the central bank purchased large amounts of Treasuries—to help long Treasuries return to their traditional role as risk diversifier. Even today, the Treasury market has been more volatile than before the pandemic.

Long duration German government bonds are a very high-quality asset that have been less volatile than U.S. Treasuries. But the news that Germany will greatly expand its government spending on defense and infrastructure has been a complete game-changer that has led me to reassess my views on bunds. German sovereign debt could now become subject to the same volatility and supply concerns that weigh on long Treasuries as a risk diversifier.

Adam: The long end of the U.S. Treasury yield curve was the perfect hedge post-global financial crisis (post-GFC) because the Fed was mostly on hold and inflation was never a realized worry. It provided "Armageddon insurance" for any and all risks involving geopolitics or flagging economic growth.

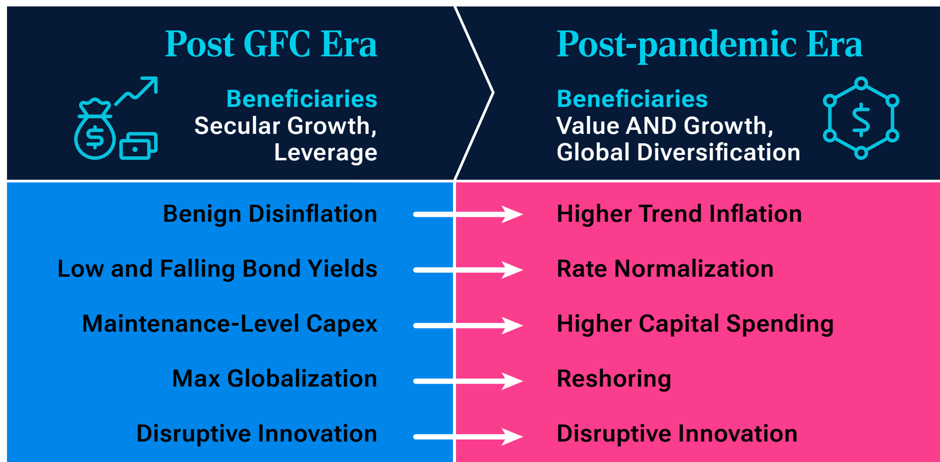
However, Treasury supply dynamics are negative today with the government's large budget deficit, and that would only get worse if we experience a growth shock that triggers even more spending. I don't think long Treasuries present many defensive characteristics today unless we see a major shift down in growth and inflation levels to what we experienced between the GFC and the start of the pandemic.

The Japanese yen is another asset that was an effective risk-off diversifier in the years following the GFC, but it has also become less attractive for the role in today's markets. As U.S. inflation has become a much more significant risk factor, the yen now trades on the difference in rates between Japan and the U.S.

Sébastien: I agree with your assessment of the yen. With the Bank of Japan slowly tightening monetary policy, the dynamics driving the currency have changed. It's vulnerable to the carry trade unwind as Japanese rates and funding costs increase,

[1] Duration measures a bond's sensitivity to changes in interest rates.

Transitioning to a new paradigm



Past performance is not a guarantee or a reliable indicator of future performance.

similar to what we saw last summer when the yen rapidly strengthened as investors anticipated a Bank of Japan rate hike.

Are there asset classes that have more recently become effective diversifiers?

Adam: Energy and some other commodities have become better diversification tools for the inflation-related risks in the current environment. In aggregate, you have geopolitical, industry structure, management incentive, and secular power tailwinds for these sectors. These factors have created a much more defensive structure than the crazy beta[2] plays that commodities were previously. But you need to be selective in terms of the specific commodity and the region.

Sébastien: It's interesting that commodities and energy were defensive when the technology bubble burst in the early 2000s as well as in the inflation-driven sell-off across asset classes in 2022. But during the GFC, commodities plummeted.

Arif: To me, the answer is cash, where you can now earn decent yield on what is probably the ultimate safe asset. This is a major change from the zero interest rate days before the Fed started to raise rates in 2022, when there was a huge cost to holding cash with little or no yield.

Sébastien: Cash is no longer trash! Cash/cash equivalents[3] is a defensive asset simply because it offers relatively attractive yield and high liquidity. FOMO pain—in terms of potential upside in risk assets—is lessened when you are getting an attractive yield.

Adam: The "Magnificent Seven"[4] equities has become its own asset class and is currently the prime defensive asset class in the eyes of the market. But there are three issues with this perception—the Magnificent Seven is more cyclical than many investors seem to think, and the companies are not "asset light." In fact, their capital expenditures relative to sales

[2] Beta is a measure of an asset's volatility relative to the market.
[3] For example, bank accounts, money market funds, or Treasury bills.
[4] The "Magnificent Seven" is Apple, Alphabet, Amazon, Meta, Microsoft, NVIDIA, and Tesla.
The specific securities identified and described are for informational purposes only and do not represent recommendations.

are rising. Importantly, their elevated valuations, combined with questionable future free cash flow conversion,[5] increase doubts about their continued usefulness as a defensive asset class.

What equity sectors would you expect to outperform in a broad-based risk downturn?

Sébastien: Value stocks should hold up better than the broad equities market. In the last 200 trading days as of February 24, the S&P 500 Index dropped more than 1% on 16 days. Value outperformed growth on all 16 days.

Within value, we are more concerned about inflation than recession risks, so we have sought inflation protection through exposure to real assets equities.[6] This is one of the very few assets that benefit from an inflationary environment. But we're aware that REITS[7] would get hit immediately if rates were to move upward with inflation.

In an old-fashioned growth shock, the consumer staples, health care, and utilities sectors would likely outperform the broad market.

Adam: I'd go with health care due to the combination of known secular tailwinds from the aging population, the more positive cyclical backdrop in sectors such as health care tools, and the more supportive industry structure in biotech. It's a very defensive area relative to all asset classes as it doesn't get hurt nearly as badly as Treasuries or other equity sectors by inflation. However, regulatory issues add nuance to the sector and make strong fundamental analysis of individual health care companies essential.

I agree that utilities are still defensive, but artificial intelligence (AI) power demands have led to a speculative valuation premium that became obvious in the AI-related selling pressure when the market grappled with DeepSeek's more efficient power intensity. This would cause utilities to lose some of their diversification benefits in an inflation-driven sell-off.

Consumer staples have the ability to provide defense in all environments. But the sector has historically needed to trade at a relatively cheap valuation to the overall market to benefit portfolios.

Aside from allocating to different asset classes or currencies, are there efficient ways within a portfolio to hedge risk exposure and limit downside?

Sébastien: Hedged equity, which can incorporate low-volatility stocks or a range of option strategies, is designed to limit downside in a variety of risk-off environments.

Adam: Market volatility is elevated in a prolonged downturn in risk assets, so strategies that benefit from higher volatility will always be defensive. However, the price of implementing these strategies is key—you can be "right" in your view but still lose money going long volatility in a risk sell-off if the price is too high.

[5] Free cash flow conversion measures a company's ability to turn earnings into free cash flow, which is cash after expenditures needed to maintain its asset base.
[6] Real assets equities are stocks of companies that derive their revenues from energy and natural resources, commodities, real estate, or other physical assets.
[7] Real estate investment trusts.

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