

Flight To Quality Stuck On Tarmac

I had a student in my fixed-income class a number of years ago who was, shall we say, talent-challenged. When it came to market movements, he kept saying one thing, “flight to quality.” He was a federal bank examiner in his day job; you are free to draw your own conclusions.

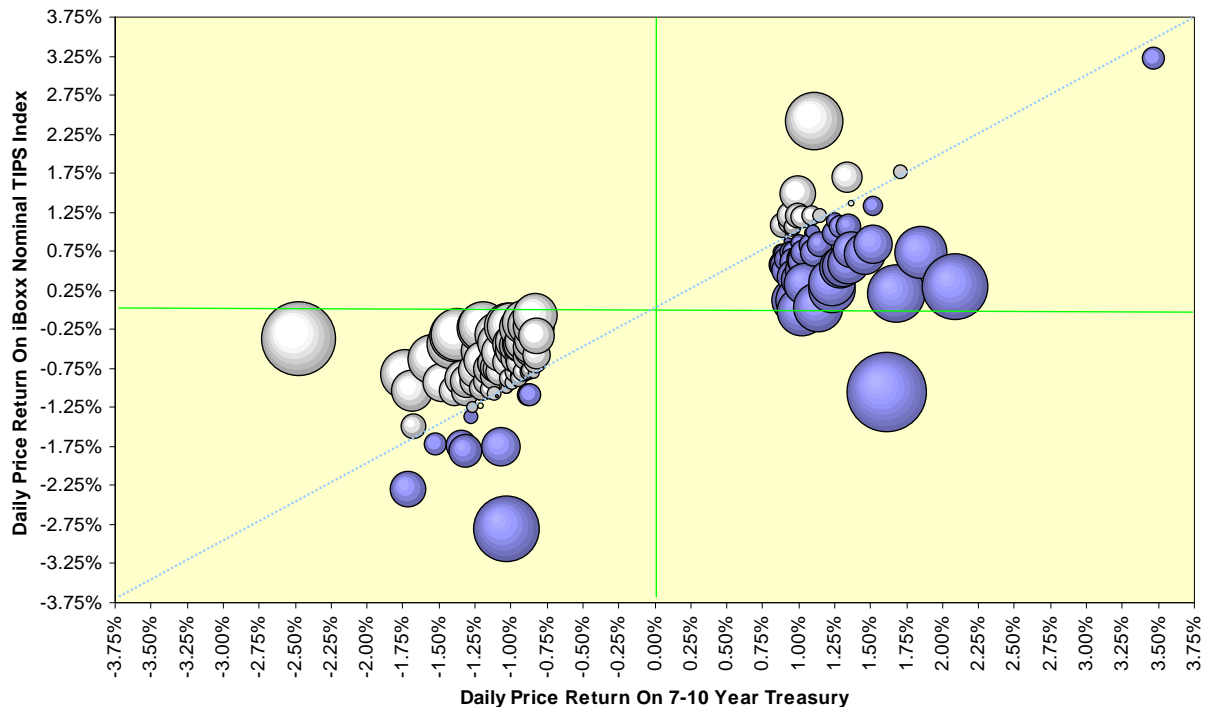
Those were the days when we did not debate whether U.S. Treasuries were AAA securities; it was assumed since Uncle Sam owned a printing press for the world’s reserve currency, the U.S. was the world’s largest economy and our public finances did not look like something crawling around under a rock that Treasuries would be a suitable last refuge. Besides, as long bonds had gone what was then limit-up for three consecutive days following the October 1987 crash, no one wanted to be short bonds once the trapdoor opened beneath stocks.

A derivative of this, discussed in a different vein in [May 2010](#), is TIPS breakevens get compressed during buying sprees for nominal Treasuries, many but not all of which are associated with selling sprees in stocks. This is the alleged process; we shall see, however, it is not as automatic as you might suppose.

Let’s switch the underlying markets from that earlier analysis from ten-year Treasuries and ten-year TIPS breakevens to the broader and more representative iBoxx Nominal TIPS and Merrill Lynch 7-10 year Treasury indices.

If we isolate Treasury changes outside of a $\pm 95\%$ confidence interval and can map the relative performance of Treasuries versus TIPS as a function of the two markets’ daily price returns. Treasury outperformance is depicted in blue; TIPS outperformance in white.

Flight Into Treasuries Depresses TIPS Return
95% Confidence Interval Since January 1, 2001



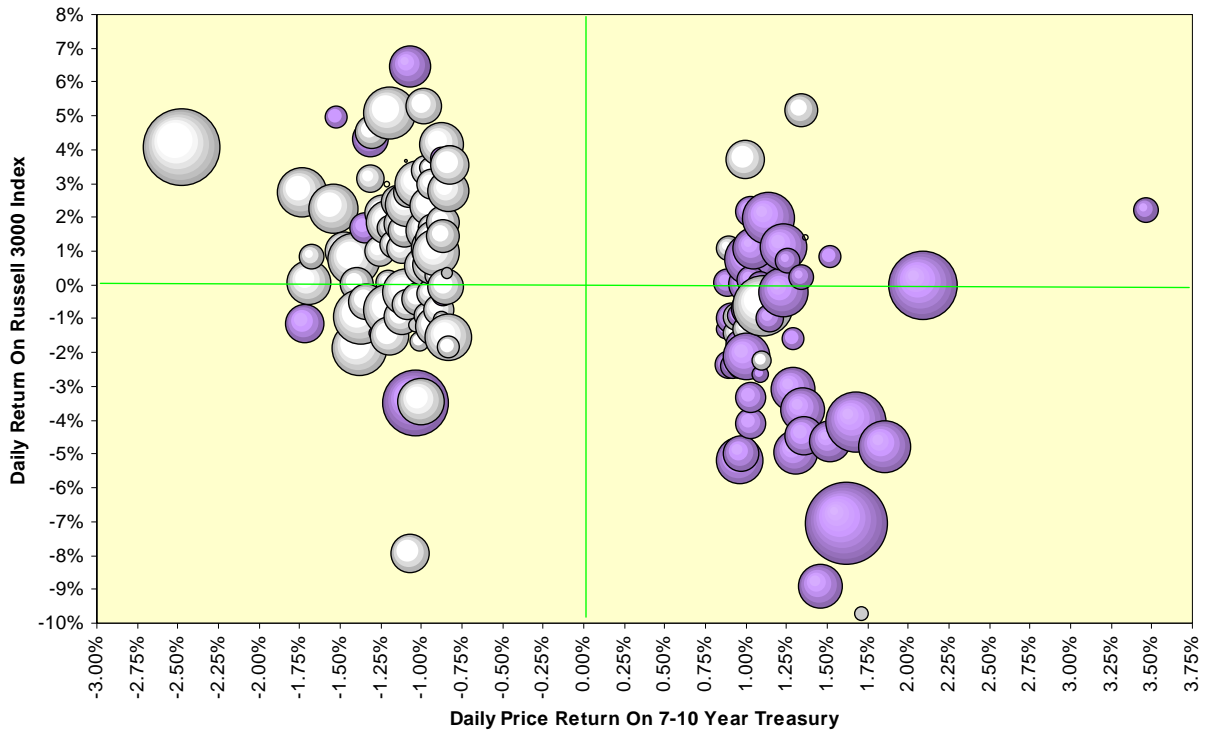
Does it surprise you that on 15 out of the 62 large Treasury rallies TIPS outperformed and on 14 out of the large Treasury selloffs TIPS underperformed? This is our first hint the whole flight-to-quality response may not be as mechanical as supposed.

Stock Shock

Now let’s match those big Treasury days up against their associated daily returns for the Russell 3000; the same scheme will be used for relative TIPS and Treasury performance. Eighteen of the large rallies and 28 of the large

selloffs in Treasuries were accompanied by stock market rallies and selloffs, respectively, the opposite of the knee-jerk reaction many expect. In addition, Treasuries underperformed TIPS during stock market rallies or outperformed them during stock market selloffs on 59 out of the 148 total observations, or 60% of the total.

Breakeven Compression/Expansion And The Flight To Quality



The message out of all of these moving parts is, mercifully, straightforward: Large Treasury changes can occur independently of large stock market changes and changes in TIPS breakevens can and do occur independently of large Treasury changes.

Restated, if you want a trading rule between stocks, Treasuries and TIPS you can write on the cover of a matchbook that will be right just about all of the time, you will not get one.