About That Flight To Quality

As we are heading into that time of year when truths are supposed to be self-evident, let's stop, smell the roses, mix the metaphors and run the banner of a flight-to-quality in the Treasury market up the flagpole of data analysis and see who salutes it. This presumes, of course, you have not done so yourself already.

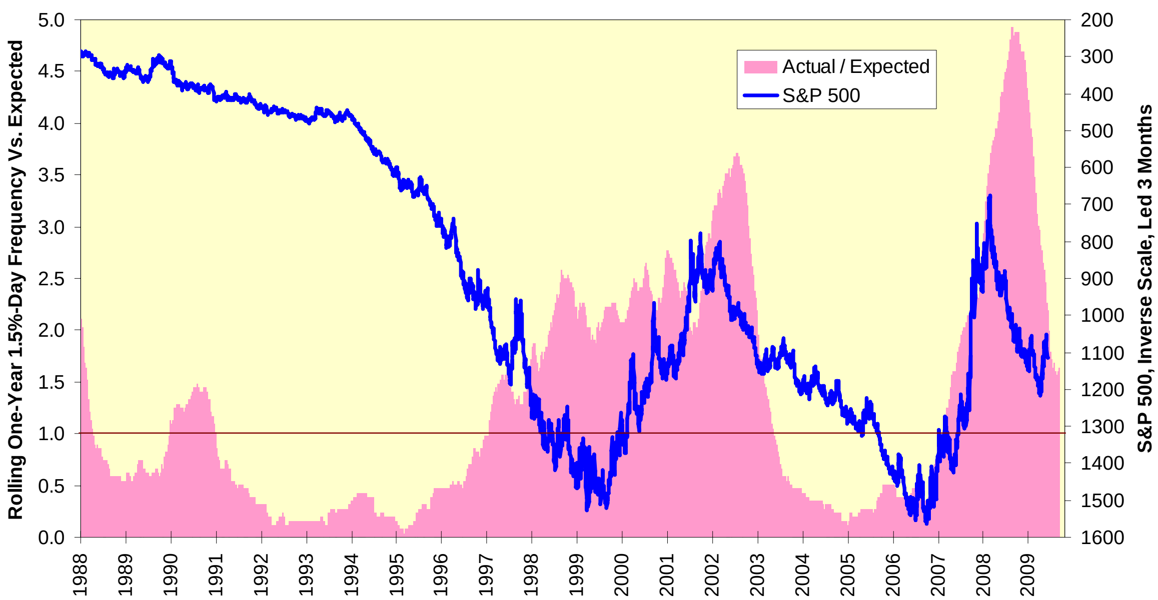
The impulse that every bad hair day in stocks has to be met with a headlong scramble into bonds was born during the October 1987 crash. Veterans of that day recall Treasury bonds hit their low for 1987 on the morning of the crash and gave you plenty of time and opportunity to cover during the day. It was only well after the market had closed when then-Federal Reserve chairman Alan Greenspan pledged to open up the taps that all interest rate instruments rallied in the overnight market and bonds traded a limit-up 3 points a day for three consecutive days on the Chicago Board of Trade.

Thus the myth was born; the counter-myth that every follow-up rally in stocks would be met by an outflow from Treasuries on the idea of, hey, who wants the (darn) things anyway did not materialize until the various financial crises of the 1990s.

Large Moves

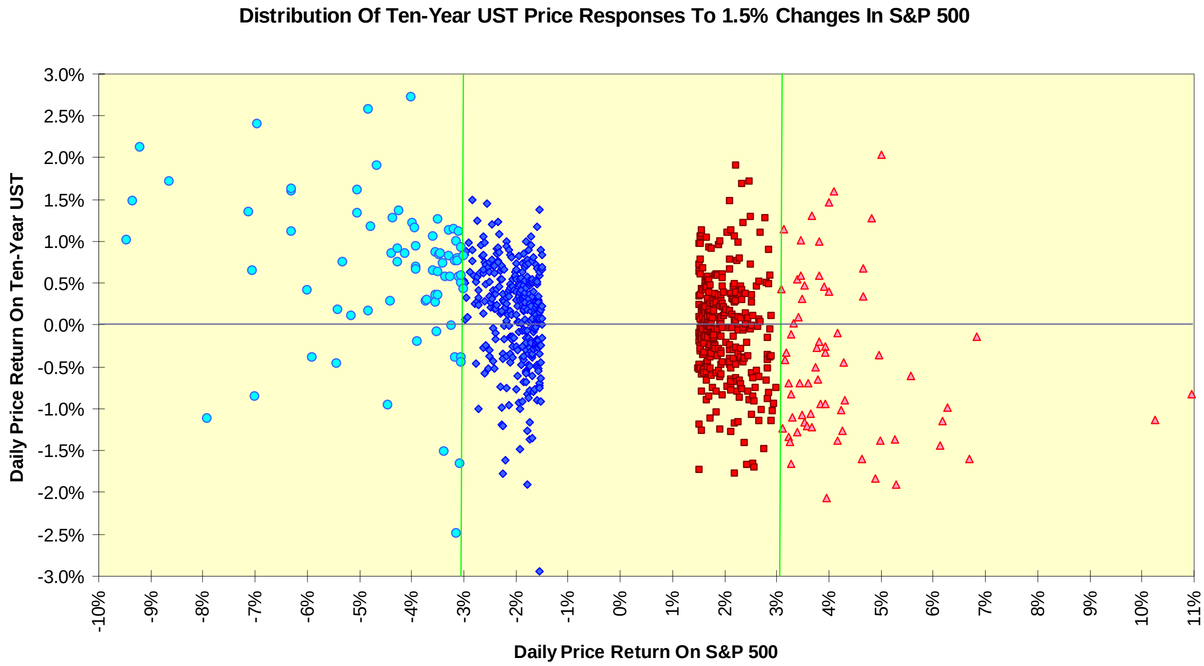
Let's use daily price changes in the S&P 500 of ±1.5% as a definition of a large move in the stock market. If you sense these moves have been occurring with greater frequency of late, you are somewhat correct. If we take a rolling one-year ratio of the actual frequency of these moves relative to the statistical expectation therefor, we find they were much more frequent both during the 2007-2008 unpleasantness and during the late 1990s rally. It is funny how we forget volatility is a two-way concept. But, yes, we are in a period marked by a large number of big moves within a market trapped in a frustrating range for the time being.

Large S&P 500 Moves Occur More Often Than Expected



Treasury Reaction

Now let's map the daily price returns for ten-year Treasuries against the ±1.5% S&P 500 moves. In addition to this bound, we can add a 99% confidence interval, marked with the green lines, to see what the effects of much larger moves have been.



If we really did have flights to and from quality, you would see pronounced negative trends in these relationships. Do you see them? You do not; they do not exist in a statistically significant sense.

This is one of the better cases of "confirmation bias" going: We remember the days where the expected events happened and forget the days where the expected not only failed to materialize, but actually moved off in another direction. "Self-evident" really should not be synonymous with, "I think so, but now that you mention it, no, I really did not bother to see whether I had any evidence for my idle chatter."