



Kevin Cousins

Rethinking 'safe haven' assets

Kevin has over 30 years' experience in investment management. Kevin joined PSG Asset Management as an investment analyst in 2015. He was appointed as Head of Research in 2017.

The US long bond has long been regarded as the 'safe haven' asset for global portfolios. This reputation was earned from nearly 40 years of strongly positive returns when risk assets sold off. Investors have been anticipating slowing growth and a recession in the US. Their response has been to once again buy massive positions in US bonds, despite 2022 marking the worst performance from developed market bonds on record.

Our research shows the US is in a state of fiscal dominance with important implications for the effectiveness of monetary policy. We believe, under most scenarios, the US long bond will not perform its safe haven role, and the majority of global portfolios are poorly positioned for the environment that lies ahead.

"Insurance that pays you to take it"

US bond yields trended down for 40 years, from 1981 to 2021. The annualised total return over this period was some 9%, compared to a CPI averaging 2.8% per annum, so the long bond real returns were also strong. Since the equity market crash in 1987, bonds have also displayed strongly uncorrelated performance when risk assets get sold off. This is driven by the so-called 'Greenspan Put', as investors anticipate monetary policy easing by the US Federal Reserve (Fed) in response to economic or market stress.

Performance comparison during recent periods of market stress

Event	Period	S&P 500 Total Return	Long Bond Total Return
Global Financial Crisis	August 2008 to 6 March 2009	-27%	14%
Eurozone Debt Crisis	April to July 2010	-21%	13%
Eurozone Debt Crisis II	July to September 2011	-17%	26%
China Devaluation	July 2015 to February 2016	-17%	15%
Powell Tightening	October to December 2018	-17%	7%
Covid	February to March 2020	-20%	10%

Source: Weekly Bloomberg data, US Long Bond represented by TLT ETF

This combination of positive long-term returns and non-correlation with risk assets has made long bonds an essential part of a portfolio for nearly four decades.

Consensus positioning is once again very long bonds

When investors fear a looming recession, as has been the case since the yield curve inverted in April 2022 and again since July 2022, massive purchases of bonds take place as portfolios load up on 'insurance'. Measures of asset manager positioning, such as the Bank of America survey, Commodity Futures Trading Commission (CFTC) net open interest for the long bond future, and the shares in issue in popular bond exchange-traded funds, all confirm a substantial overweight in bonds.

What changed in 2022?

In the first nine months of 2022, the S&P 500 Index delivered a total return of -16%. *Instead of protecting portfolios as a safe haven, by the time the equity market bottomed in September, the US long bond's year-to-date return was a devastating -36%!* Our research focuses on what caused this first failure in nearly 40 years, and why investors' bond purchases, despite the higher prevailing yields, have a low probability of acting as a safe haven in the years to come.



Pro-cyclical fiscal policy means trouble ahead

That monetary policy dominates the bond price formation process is the essence of the 'Greenspan Put'. A key assumption to this continuing is that the US maintains prudent fiscal policy. This has been sorely tested, firstly with the Trump tax cuts in 2017, which resulted in a budget deficit of some 5% at the peak of the economic cycle in 2019. This contrasts with a 2.5% budget surplus the last time unemployment was also below 4% (under Clinton). Secondly, the stimulus programmes under President Biden have pushed the current deficit to 8.5% despite an unemployment rate once again at 50-year lows.

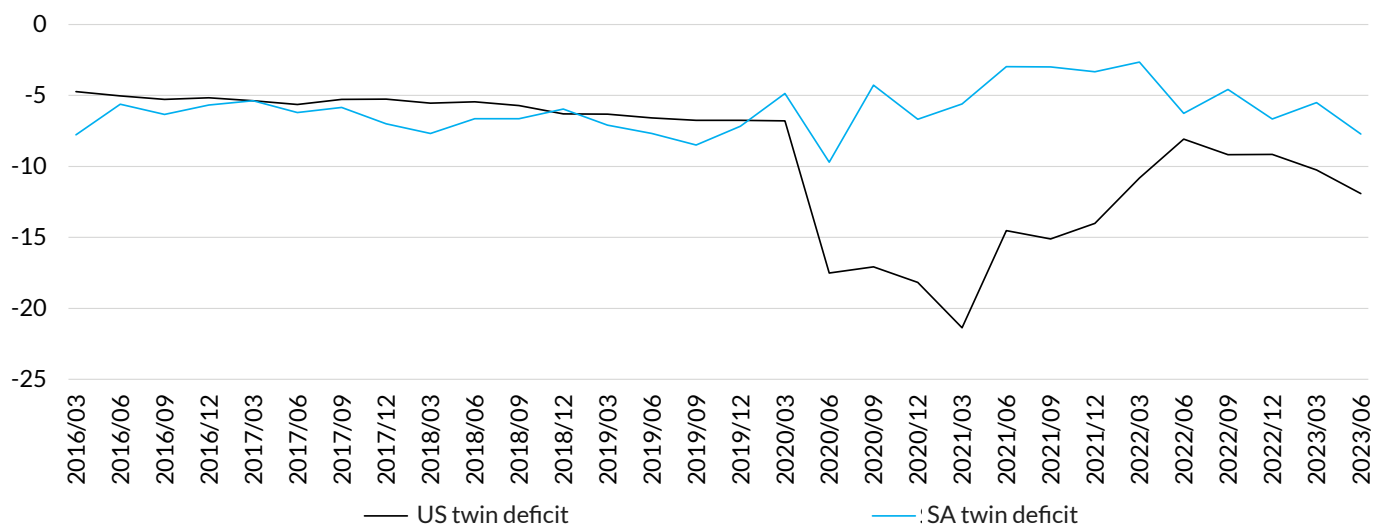
Why is this important? When the next recession finally arrives, there is little doubt that US policymakers (of either party) will reach for fiscal stimulus spending that proved

so effective in the aftermath of the Covid-19 pandemic. This, combined with the normal recessionary decline in tax revenues, will widen the deficit between 5 and 10 percentage points from the current level, i.e. deep into the teens.

US deficit now resembles an emerging market's in the 1980s

A good snapshot of a nation's macroeconomic vulnerability is captured by the so-called 'twin deficit', the budget deficit added to the current account deficit. The chart below compares the twin deficits of the US and South Africa. Despite the political upheavals and economic hardship, SA's twin deficit has been dramatically lower than that of the US.

Twin deficits as % of GDP



Sources: PSG Asset Management and Bloomberg

South Africans are often pessimistic about our country, so it may come as a shock to know that over the past three years, SA bonds have delivered a positive USD total return (+10%) while the US long bond has had a total return of -42% (both to end of September). SA bonds, in US dollars, outperformed by over 50 percentage points!

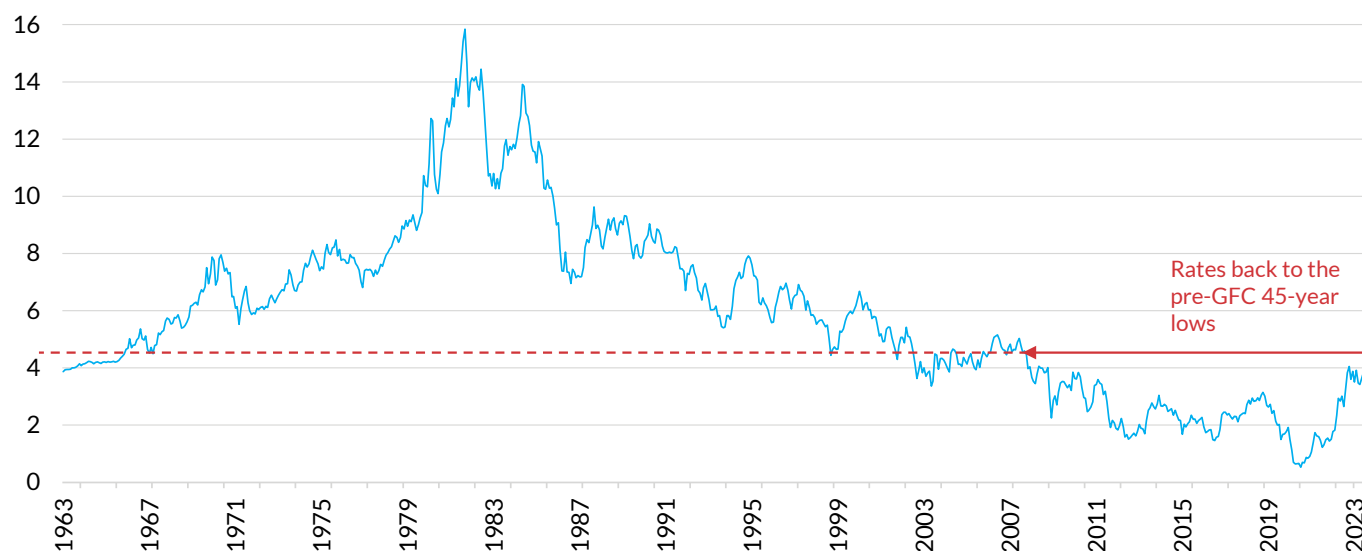
Are US rates now pricing in the macro fundamentals?

The record sell-off in developed market bonds in 2022 and 2023 has restored yields to levels above the current inflation rate in the US. The huge positioning in bonds also shows that the consensus view is that these yields are back at attractive levels. However, our research shows that over our investment horizon, current US bond yields do not compensate you for what we believe are significant risks.



While yields have risen, they are not high relative to history, on either a nominal or a real basis. The recent period post the 2008 Global Financial Crisis (GFC) to 2021 is likely to be a poor frame of reference for the future environment.

US 10-year Treasury Bond Yield (%): 60 years from 1963



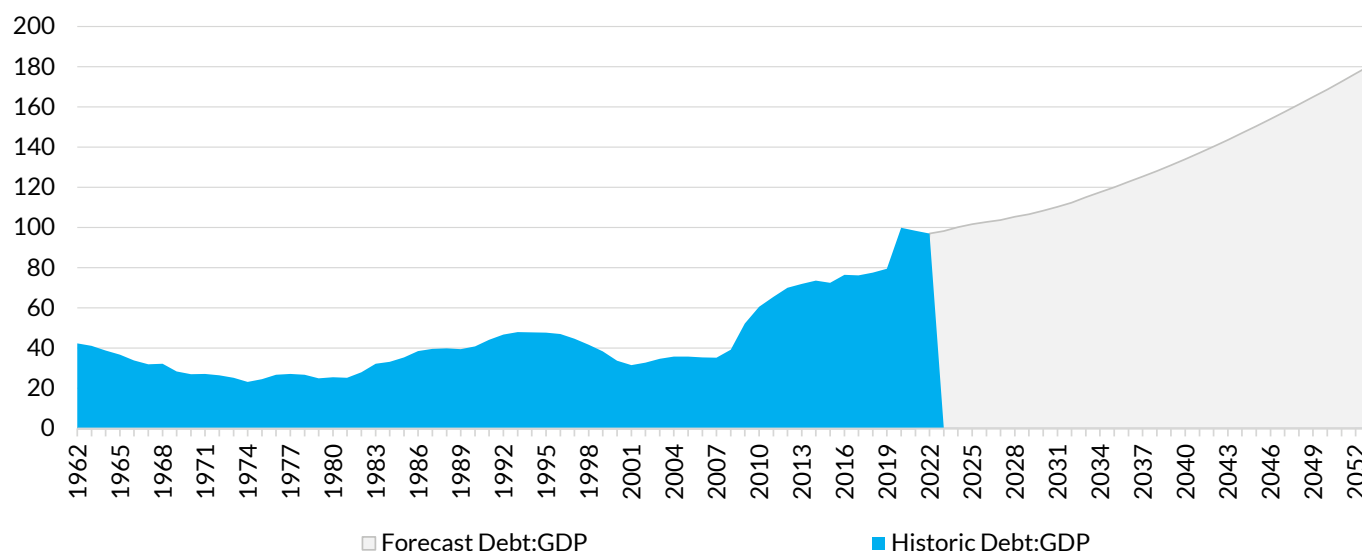
Sources: Bernstein and Bloomberg

Fiscal dominance is here

In addition, the US primary deficit is forecast to remain wide, as entitlement spending on social security and healthcare is boosted by the ageing Baby Boomers. In fact, in the current polarised political environment, it appears the only thing that the Democrats and Republicans agree on is that defence and entitlement spending cannot ever be cut.

Given their significance in the budget, this effectively means any plan to reduce the deficit is doomed to fail. *The US currently has the highest debt-to-GDP burden since the Second World War, and given these deficit constraints, debt is forecast to rapidly rise to unprecedented levels.*

US Federal Debt as a Percentage of GDP



Source: Congressional Budget Office



Furthermore, the Congressional Budget Office (CBO) forecasts assume that interest rates on government debt rise very slowly, to 3.0% in the first decade, 3.4% in the second decade and 3.75% in the third decade. The interest burden is currently growing very rapidly and the US government already spends more on debt service than defence. What the CBO forecasts appear not to take into account is how short dated the majority of US debt is.

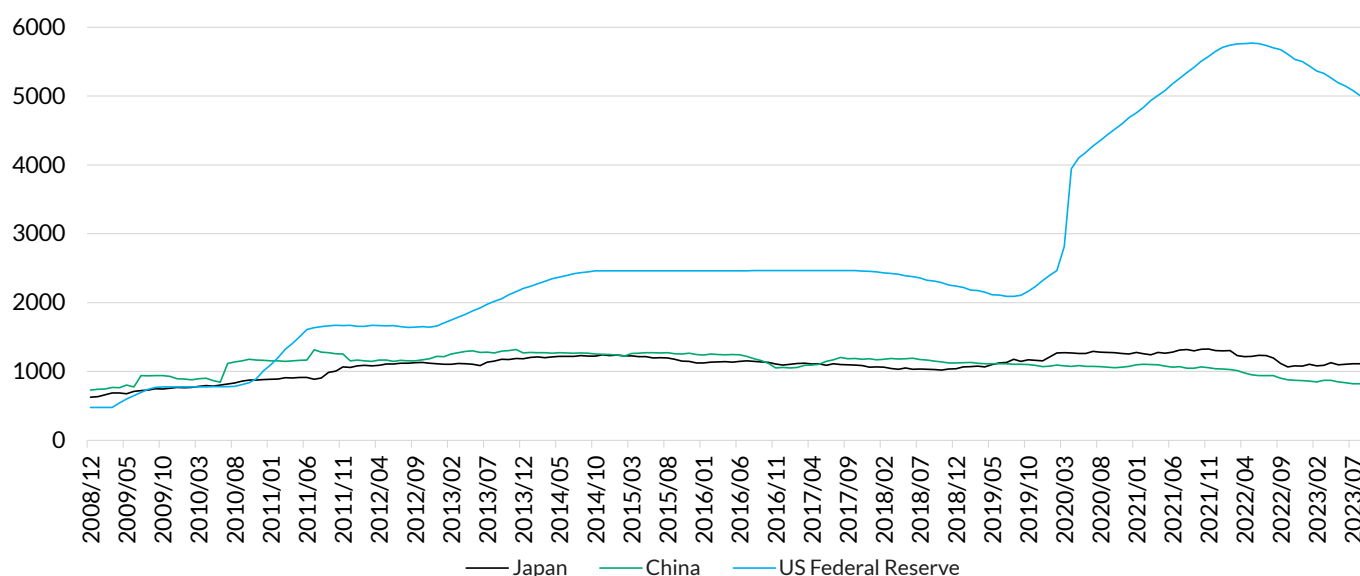
Our research shows that of the current Federal debt burden of US\$26 trillion, nearly 50% needs to be rolled before the end of 2025. If we add to this the expected budget deficits, we get a funding requirement of some US\$17 trillion.

This is 63% of current GDP. By comparison, South Africa's funding requirement is estimated at 15% of GDP over the same time period.

Who will buy US\$17 trillion over two years, and at what rate?

The three largest holders of US debt are the Fed (after the long period of quantitative easing), and trade surplus countries Japan and China. Both of these countries have been reducing their positions, and the Fed is currently letting its debt holdings roll off as they mature in terms of their Quantitative Tightening programme.

Largest Holders of US Federal Debt (USDbn)



Sources: Bloomberg, US Treasury and US Federal

At what yield will the US find buyers for this vast issuance of debt? A market clearing yield is likely to be considerably higher than the current curve, which in turn will further increase the debt service burden. This would make the CBO debt projections look optimistic, further stressing demand for Treasuries.

There is only one buyer that can take this volume of issuance, and that is the Fed

Allowing the market to set long bond yields in the face of the massive wall of supply, risks the negative feedback loop described above and hence a rapidly escalating crisis. *In a fiscally dominant world, the central bank's mandate is severely constrained by both sovereign funding needs and possible private sector credit stress. This is largely ignored by most market participants, who believe that interest rate policy is still pre-eminent and will drive future bond price formation. We believe there is a significant probability that fears of a rapidly widening deficit (typical of recessions) will be as important in determining long bond yields as rate cut expectations. This has important implications for the safe haven asset.*

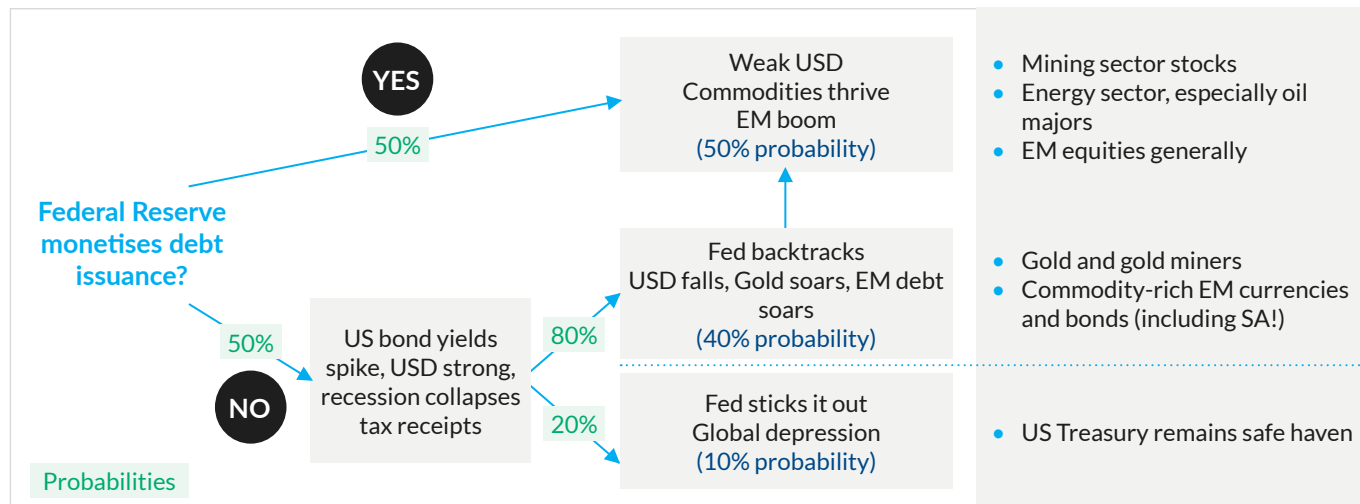
Debt issuance scenarios

A consequence of the Fed 'hanging tough' and letting the market determine bond yields could be a deep global recession. This is a very unlikely scenario, however. The recent rise in bond yields has already been cited by several Fed voting members as a significant tightening of financial conditions. *The probability that the Fed will step in on a yield spike and monetise US debt is very high.* Policymakers have acted to alleviate any signs of economic and market stresses for many years now, and should the Fed initially hold out, they are likely to pivot as those stresses become visible.

The implications of debt monetisation for the safe haven asset are significant. To expect what worked when monetary policy was dominant to continue to diversify portfolios has already proved to be an expensive error. The Fed intervening to restrain bond yields is likely to result in a weak USD environment, and strong performance can be expected from commodities, emerging markets (EMs) generally and the bonds of commodity-rich EMs in particular. Gold will also play a key role as a portfolio diversifier.



US debt issuance decision tree and safe haven assets



Sources: PSG Asset Management and Gavekal

Conclusion: The new safe havens in a volatile world

The period of **secular stagnation and monetary dominance** is over. This will continue to be a very volatile macro environment. Investor portfolios will be well served by:

- including the safe haven assets shown against the high probability scenarios in the figure above
- avoiding long duration assets such as US long bonds and 'high growth' stocks with very high ratings
- sensibly using portfolio hedges, cash holdings and global diversification (as opposed to being US-centric)
- taking a longer-term view and accepting that historic quantitative measures of price volatility calibrated during the secular stagnation may be poor risk proxies

In addition, many of the 'new safe havens' are what we would consider short duration assets with high near-term yields and wide margins of safety. *Finally, the energy and gold sectors have embedded optionality to the price spikes that typify geopolitical upheavals. Recent events have been a sombre reminder of how important this may be for portfolios in the future.*



A thought experiment

We expect Federal debt to reach US\$30 trillion by 2025. What if 1 holder in 10 seeks an alternative safe haven? This would be US\$3 trillion of buying power.

Some alternative safe havens and illustrative 'market caps':

- Gold US\$2.9 trillion (gold bars, ETFs and coins excluding central bank holdings)
- Commodity-rich EM bonds US\$2.3 trillion
- Integrated oil majors US\$1.4 trillion

What would be the clearing price for that US\$3 trillion to be invested in these assets?

Contrast this with the 'clearing yield' for the US government to place US\$17 trillion of debt over the next two years.

Now, what is your safe haven asset?