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Central question in Treasury drama

From Dr Sanjay G. Reddy.

Sir, Gillian Tettœs instructive articleThe unmasking of our inner reptiles in times of crisiso (August 13) addresses the question of why funds are flowing into the short-term Treasuries market, even in the immediate aftermath of the US rating downgrade. The question can perhaps be put even more sharply. The recent market turmoil appears to be a result of a reduction in the deemed quality of US Treasuries. How then can one explain that a central feature of the recent drama is an increase in the relative valuation of that very asset?

The existence of a large pool of funds that must be put somewhere is an insufficient explanation, since that pool existed both before and after the triggering event. One explanation is that the rating downgrade has caused a change in investor expectations regarding the ability of the US to maintain a low interest rate regime, which will inevitably raise the cost of borrowing and thereby of investment and debt-fuelled consumption.

Another explanation is that the rating downgrade has caused a change in investor expectations regarding the USœs ability to engage in needed economic stimulus in th short run. The ability of the US to serve as an importer of last resort for countrie s pursuing export-oriented development strategies is also thereby jeopardised.

For all these and perhaps other reasons, the downgrade may have had a more adverse indirect impact on share prices than it has had directly on Treasury bonds. It is no t so much that investors wish to hold Treasury bonds, as that they do not wish to invest in shares in the real economy, about whose prospects they are increasingly jittery. Thi s would be but a platitude were it not that the precipitating factor has been the worr y about these bonds themselves.

When the Oanimal spiritso of investors are at play, a great many surprises are possble.

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