Competing Models of US Treasurys

Implications for Monetary/Fiscal Interactions

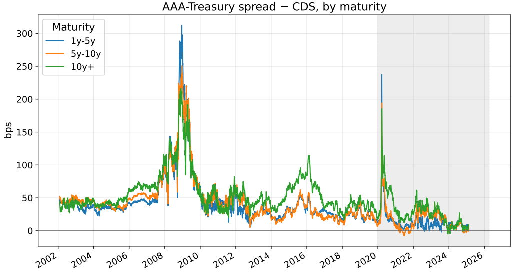
Hanno Lustig

Stanford Graduate School of Business

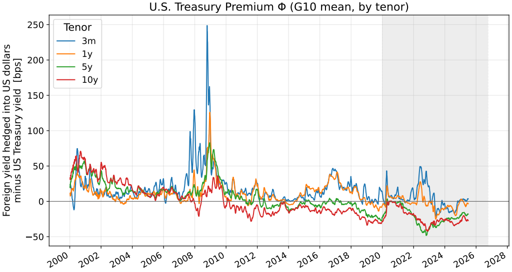
Pre-2020: Market participants viewed USTR as safe

- USTR earned **large convenience yields** (safety and liquidity).
- USTR were **expensive** compared to close substitutes:
  1. **AAA corporate bonds**.
  2. **Foreign sovereign bonds**.
- Stock-bond correlation was negative.
- Flight to safety in stress events.

Convenience yield wedges: corporates and foreign sovereigns

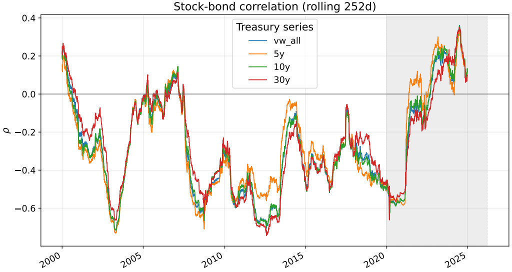


AAA-Treasury spread, CDS-adjusted.
Mota (2024); plotted $\text{spread} - \text{CDS}$.

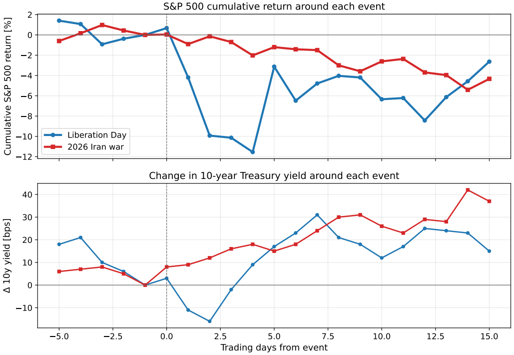


Foreign sovereign−U.S. Treasury spread.
Foreign yield hedged into USD minus UST. G10 equal-weighted mean.

Stock-bond correlation and recent stress events



Stock-bond correlation (rolling 252d).
Daily Treasury returns vs. CRSP-VW equity.

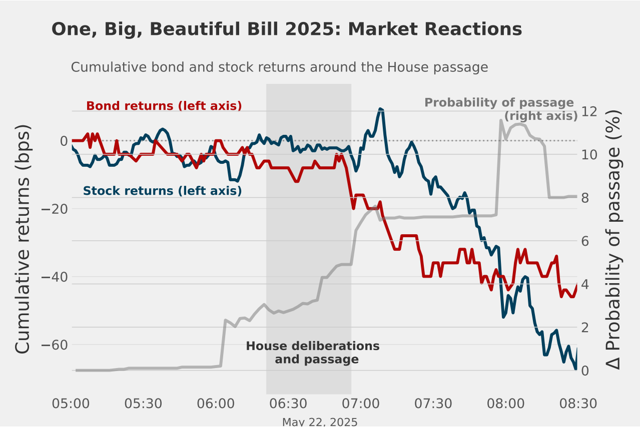


Liberation Day: 2025-04-03. 2026 Iran war: 2026-03-02. Source: FRED.

Post-2020: Market participants no longer view USTR as safe

- USTR no longer earn **large convenience yields** (safety and liquidity).
- USTR seem **cheap** compared to close substitutes:
  1. **AAA corporate bonds**.
  2. **Foreign sovereign bonds**.
- Stock-bond correlation turned positive.
- No flight to safety in stress events.
- Treasury yields respond to fiscal news.

One Big Beautiful Bill



- Cumulative Treasury and equity returns ↘ sharply after the OBBB was passed in the House (upward revision in enactment probabilities).

Post-2020 Market Participants: Risky Debt

		⇓ *Post-2020 Market Participants*
Regime	**Safe**	**Risky**
Leading authority?	Central Bank	Government
Who bears g risk?	Taxpayers	Bondholders
Large $g \nearrow$ fully funded by future τ	Yes	No
Market Beta	Zero	Positive
	Bond Market Response to Fiscal News	
Treasury Yields (ex CY)	No	Yes ✓
Term Premia	No	Yes ✓
Long-run Expected Inflation	No	Yes ✓
CY	Yes	Yes ✓
	Response to Market Stress	
		Anticipated
	Flight to Safety	Mark-to-Market
Stock-Bond Correlation	Negative	Positive ✓
Yields	$\searrow$	$\nearrow$

g (τ) denotes government spending (tax revenue). s denotes primary surpluses. CY denotes convenience yield.

Post-2020: Policy makers' models treat government debt as safe

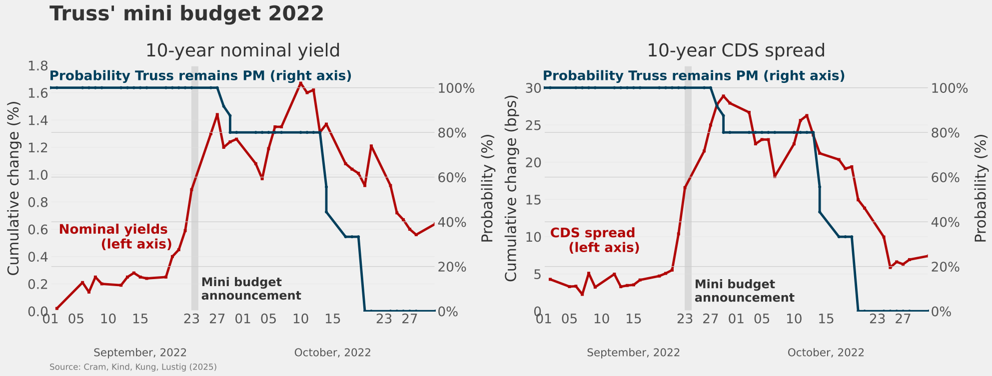
- **Central bankers** still use macro models in which government debt is safe.
  - All government spending is fully funded.
  - No role for the government debt valuation equation (or the intertemporal budget constraint.
  - Government cost of funding is exogenous (does not respond to fiscal policy).
- **Financial regulators** still use models in which government debt is safe.
  - Risk weights for government bonds.
  - Money market fund regulations.
- **But market participants use a different model.**
  - Central bankers and financial regulators second-guessing bond markets.
- Risk: central banks use a large balance sheet to fix plumbing problems that aren't.

Post-2020 Policy Makers: Safe Debt

	⇓ *Post-2020 Policy Makers*	
Regime	**Safe**	**Risky**
Leading authority?	Central Bank	Government
	Bond Market Response to Fiscal News	
Treasury Yields	No	Yes ✓
	Response to Market Stress	
	Anticipated	
	Flight to Safety	Mark-to-Market
Stock-Bond Correlation	Negative	Positive ✓
Yields	$\searrow$	$\nearrow$
	Actual: Yields $\nearrow$	
Interpretation	Market Dysfunction	Market functioning
Causes	Market Micro-structure	Macro
	Plumbing	Fiscal News
	Large Scale Asset Purchases	
Objective	Liquidity Provision	Price Support ✓
Price Discovery	Improve	Impair
for Taxpayers	Create Value	Destroy Value ✓

g (τ) denotes government spending (tax revenue). s denotes primary surpluses. CY denotes convenience yield.

UK mini-budget (Sept 2022)

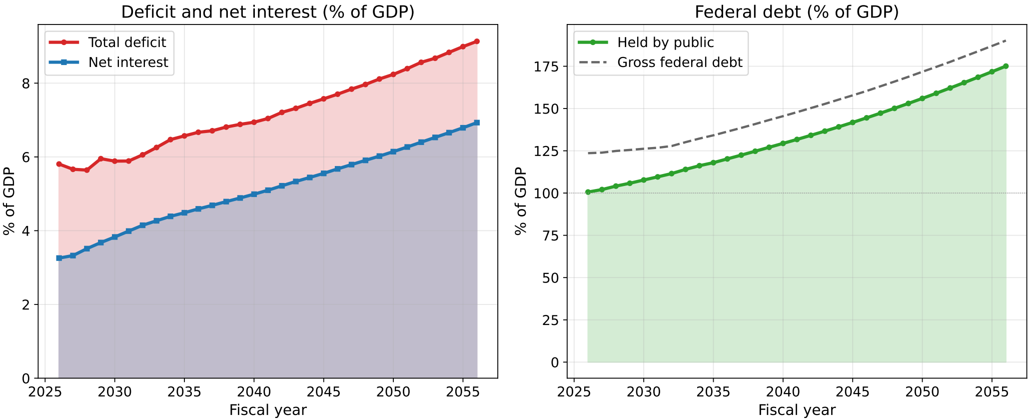


- ▷ Gilt yields ↗ during Kwarteng's delivery of the mini-budget (£45B **unfunded tax cut**) starting at 8:30am on Sept 23, 2022.
- ▷ Yield response driven by concerns about fiscal sustainability as CDS spreads ↗ *(different channel than the U.S. and larger elasticities)*.

Fragility in Treasury Markets

- U.S. Treasury increasingly relying on **T-bill issuance** — convenience yields on longer maturities have eroded.
- U.S. Treasury increasingly relying on **hedge funds** to absorb large issuance.
  - Primary dealers have limited balance-sheet capacity.
- Fragile arrangement.
- Fiscal challenges and plumbing problems in Treasury markets are **intertwined**.

Need Market Discipline



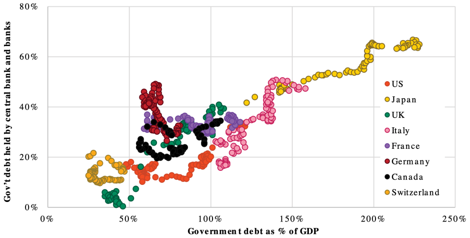
CBO Long-Term Budget Outlook (Feb 2026), extended baseline, FY 2026–2056.

Conclusion

▷ **Market participants and policy makers use competing models of U.S. government debt.**

▷ Fiscal shocks get **relabeled as plumbing problems** — creating space for bond market intervention–blunt market discipline.

▷ Central banks end up with **large balance sheets to warehouse bonds** (or banks are incentivized to do the same)–> financial repression and/or inflation.



Source: BlackRock

References I

Du, W., J. Im, and J. Schreger (2018). "The U.S. Treasury Premium." *Journal of International Economics* 112, 167–181.

Mota, L. (2024). "The Corporate Supply of (Quasi) Safe Assets." Working paper.

Jiang, Z., A. Krishnamurthy, and H. Lustig (2021). "Foreign Safe Asset Demand and the Dollar Exchange Rate." *Journal of Finance* 76(3), 1049–1089.