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China Calling

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Changing Chinese demand for Treasuries impacts both the bond market and inflation.

Update to strategic view
US BONDS: With the possibility of Fed intervention still in play, it remains too early to sell long Treasuries. But eventually the triple-threat of excessive issuance, exit by foreign buyers, and monetary inflation will trigger a savage bear market.
[see Investment Strategy Dashboard]

We certainly can't blame Chinese Premier Wen Jiabao for forthrightly expressing his concern about the "safety" of China's enormous investment in US Treasuries. As America's largest creditor, with holdings worth about $740 billion, the Chinese have good reason to be very wary about the outlook for US government bonds. They stand to absorb a substantial hit when, as we expect, the Treasury market eventually suffers a significant downside repricing for the consequences of the current policy environment (see "Treasuries: Too Late to Buy, But Too Early To Sell" January 16, 2009).

That day of reckoning has not yet arrived, and still figures to lie some months off. Treasury trading has been fairly volatile over the past month, but within a range that has been topping out at about a 3% yield on the 10-year. Even as the current condition of the US economy and financial sector remains distressed, circumstances are even worse in much of the rest of the world, and Treasuries continue to attract capital fleeing the turmoil. The latest Treasury International Capital data, although tracking flows from two months ago, shows *private* foreign investors purchased $12.7 billion worth of Treasuries in January, up from $11.8 billion in December. At the same time, the Fed's custody holdings of Treasuries for foreign *official institutions* -- which is largely a measure of dollar reserve holdings of foreign central banks -- rose $35.7 billion in January, and another $36.9 billion in February. It is growing year-on-year at a rate of nearly 40%.

About one third of this is a substitution effect. Since the onset of the worst of the credit crisis last summer, foreign official institutions have reduced their holdings of US agency securities -- mostly Fannie and Freddie MBS -- by $160 billion. Over the same period, their Treasury holdings have increased by $410 billion. A large fraction of their agency selling has been absorbed by the Fed's MBS purchase program. The first order consequence of the Fed's intervention is to prevent selling by foreign central banks from driving mortgage rates higher. But an important second order consequence is that, through the acquisition of MBS from foreign central banks who then buy Treasuries with the proceeds, the Fed is indirectly buying Treasury debt.

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This is consonant with indications from the Fed that it may buy Treasury debt *directly*, and long-maturity yields surely continue to be held in check by speculation that the Fed will soon follow-through. Tomorrow's FOMC statement may contain language addressing that possibility with more specificity. Even as its assets have expanded by more than $1 trillion on net over the past six months, leading up to this meeting the Fed was reportedly exploring options for even more aggressive liquidity additions. In the face of the Treasury's mushrooming borrowing requirements to fund the expansive agenda being put in place by the Obama administration and a Democratic Congress, the Fed may believe it needs to act so as to keep yields from escalating and further delaying an economic recovery and stabilization of the credit markets.

That would amount to outright monetization of government debt, which is a step commonly seen as breeding hyperinflation. At present, that is not a risk. To this point, the Fed's liquidity injections have largely been necessary to accommodate the burgeoning demand for money spurred by the extreme risk abhorrence beginning last fall (see "Deflation Takes Center Stage" November 19, 2008). In the fourth quarter of last year, M2 velocity fell at an annual rate of more than 20%. Failing to meet that spike in money demand would have brought on a nightmare slide into a deflationary spiral. As it is, CPI is now running at about -10% on a 3-month annualized basis, although that's an uptick from the 14.7% rate through December. The next reading from the government's benchmark price index, covering February, comes tomorrow.

Already, the Fed is committed to at least another $1.5 trillion in asset accumulation with mortgage-backed securities purchases and lending through the TALF program. We took it as a sign that the Fed was getting ahead of the curve on money demand when gold breached $1000 last month (see "Stocks Test the Lows, Gold Tests the Highs" February 23, 2009). Although it has since fallen back to below $920, that's about $240 -- or about 35% -- above its lows last fall at the worst of the panic-induced surge in money demand. More likely than not, the Fed's commitment to a continued accelerated pace of expansion of its asset holdings will mean further upside for gold, and eventually the entire commodity complex. And at some point, as markets stabilize and money demand eventually normalizes, the inflationary implications of this policy exercise will become fully evident. That is, unless the Fed can unwind the liquidity overhang in sufficiently expeditious fashion, which we have little reason to expect. At that point, the downside risk in such a richly priced asset class will become inescapable.

The Chinese, it should be noted, are already taking steps to hedge their Treasury exposure. Earlier this month, the State Reserve Bureau announced that it would be purchasing 25% of the outstanding copper inventory on the London Metals Exchange. Whatever funds will be used for this purpose, it can be seen as an alternative to further Treasury buying. The Chinese must be reasoning "why not?" -- with the opportunity cost in Treasuries so low, and with domestic warehouse capacity in excess. Most critically, this can be seen as representing the classic impulse by which inflationary influences set in, even in a world in which the normal "transmission mechanisms" for monetary excess seem to be broken. Essentially, the Chinese are eschewing paper dollars in preference for tangible goods, which is the fundamental process that always sets in train the velocity acceleration characteristic of all inflations.

BOTTOM LINE: The Chinese concern about their Treasury holdings is well-founded, but what is likely at some point to become a serious bear market is not yet at hand. Treasuries remain the first choice of global market players seeking refuge from their home market turbulence. Support is also being maintained by speculation that the Fed will soon begin large-scale purchases of government bonds. For now, that's all to the good, given the still-elevated state of money demand arising from the ongoing credit market crisis. Inevitably, though, an inflationary price will be paid, which won't be pleasurable but is a far preferable outcome to the deflationary spiral that was a real threat not too long ago.