LPL RESEARCH

BOND MARKET PERSPECTIVES

May 8 2018

TO SELL OR NOT TO SELL
THE CHINA/TREASURIES DILEMMA

John Lynch *Chief Investment Strategist, LPL Financial*
Colin Allen, CFA *Assistant Vice President, LPL Financial*

KEY TAKEAWAYS

China could sell its holdings of Treasuries, potentially leading to higher U.S. rates.

While possible, we believe it is improbable given the negative feedback loop it would create.

Foreign demand should remain a tailwind for Treasuries, all else equal, due to attractive U.S. yields relative to foreign alternatives.

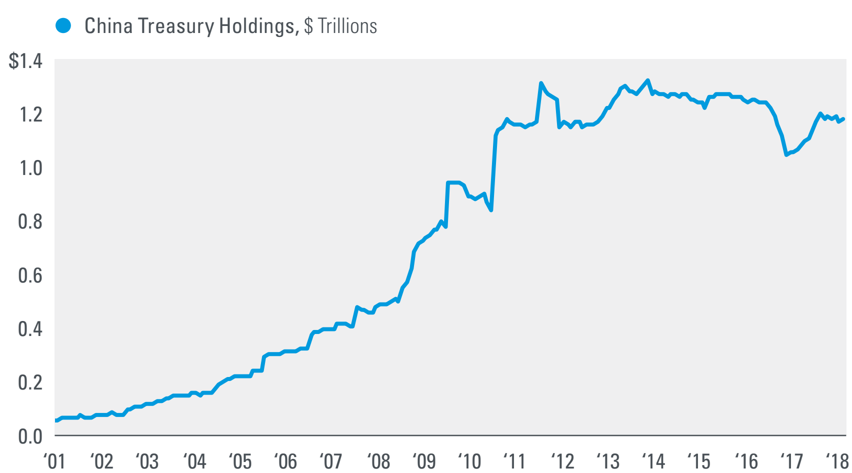
The threat of China liquidating Treasuries as a bargaining chip in trade negotiations remains a possible scenario, but in our view a highly improbable one. As the saying goes, "If you owe a bank $100, you have a problem. But if you owe a bank $1,000,000,000, the bank has a problem." China owns a large amount of U.S. Treasuries ($1.2 trillion, to be precise) [Figure 1]. The most recent data from the U.S. Treasury indicate that China actually increased its holdings during February. More updated data will be available next week, which could give investors more insight into China's intentions.

We don't believe China will reduce these holdings drastically, as the nations' fates are ultimately linked, and selling Treasuries wholesale would likely not lead to China's desired outcome. Additionally, the U.S. Treasury market is arguably the safest and most liquid in the world, making Treasuries a difficult investment to avoid entirely.*

COULD CHINA SELL TREASURIES?

The short answer is yes. Given the size and liquid nature of the Treasuries market, there is no mechanism (aside from geopolitical pressure) that could prevent China from selling its holdings in the open market. It likely wouldn't, however, at least

1 CHINA'S TREASURY HOLDINGS HAVE BEEN FAIRLY CONSISTENT FOR SEVEN YEARS



Source: LPL Research, Bloomberg 05/07/18

*U.S. Treasuries may be considered "safe haven" investments but do carry some degree of risk including interest rate, credit and market risk. They are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.

LPL Financial

not a considerable amount, for reasons we discuss later. The negative implications of selling may be significant for the U.S., however, given that Treasury supply is already elevated (to fund recent fiscal stimulus) and the Federal Reserve (Fed) is scaling back its balance sheet.

...BUT WOULD IT?

Although China certainly could liquidate its Treasury holdings to follow through on threats made during tariff negotiations, we think ultimately it's unlikely to do so. If China's aim were to sell Treasuries to the point where U.S. interest rates spiked, leading to a downturn in the U.S. economy, it would ultimately have a deleterious effect on the Chinese economy as well. Global economies are interconnected more than ever before. A severe downturn in the U.S. economy would lead to crimped demand for Chinese products, lower investment, and an inevitable downturn in its economy as well.

Additionally, selling Treasuries would strengthen China's currency, the yuan, which would have negative implications for the country's exports and thus its economy broadly. So while this narrative makes for great headlines, we believe it is ultimately not a viable negotiating tool. The Chinese government is much more likely to employ a measured, strategic approach.

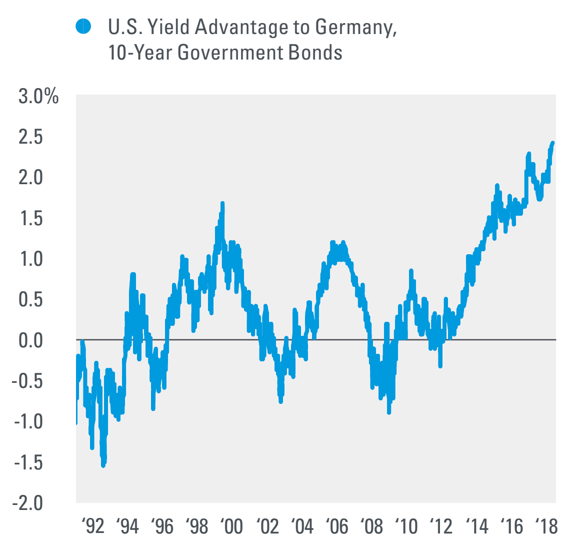
WHAT WOULD HAPPEN?

China composes 20% of foreign holdings of Treasuries, but only 5% of Treasuries overall. Still, China selling large amounts of Treasuries would almost certainly lead to an increase in rates, though it is very difficult to estimate the likely impact given the complexity of the global economy and the host of feedback loops. Estimates by some market participants are in the 25–50 basis point range (0.25–0.50%); sudden heavy selling by China could drive an even larger increase in longer-term Treasury yields. Although this would be a material increase, it is far from the doomsday hyperbole that typically accompanies conversations about China selling Treasury securities in volume. Of greater concern is the feedback loop of selling that it could catalyze. Other foreign Treasury owners, such as Japan, which owns about $1 trillion of Treasuries, may be prompted to sell Treasuries if prices plunge.

OTHER FOREIGN PERSPECTIVE

Year to date, yields have broadly notched higher for many developed foreign government bonds. Despite this, the U.S. still retains the highest-yielding 10-year bond among developed foreign nations. Its yield advantage over the 10-year German bund, for instance, is at an all-time high, surpassing the recent highs from late 2016 [Figure 2].

2 10-YEAR TREASURY YIELD ADVANTAGE TO GERMAN BUND AT ALL-TIME HIGH



Source: LPL Research, Bloomberg 05/07/18

Illustration is historical and no guarantee of future results.

Foreign demand has been a source of strength for Treasuries in recent years, as low overseas yields have pushed foreign investors toward relatively higher-yielding U.S. bonds. Upcoming auctions this week may give investors indications of foreign investors' appetite for Treasuries, especially given the recent run-up in the 10-year Treasury yield to near 3%.

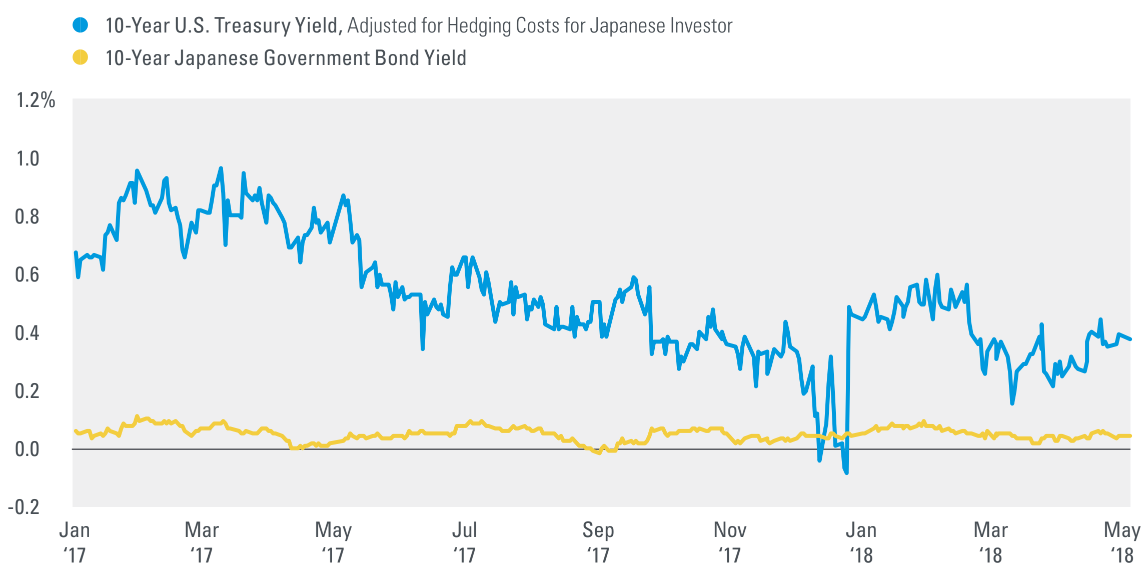
However, yield isn't the only factor that foreign investors have to consider when investing in the U.S. When a foreign investor purchases a Treasury security, this must be done in U.S. dollars. If the dollar depreciates relative to the investor's home currency, the investor receives less of the local currency back for each dollar, reducing the total return. Given that exchange rates can be volatile, a depreciating dollar could wipe out a significant portion (or all) of any yield advantage the investor would see from investing in the U.S., especially with interest rates at low absolute levels.

For this reason, many foreign investors choose to hedge dollar-denominated investments by using currency futures. To do this, an investor would purchase dollars at the current exchange rate (known as the "spot rate"), and simultaneously sell his or her local currency at a contracted price set by futures or forwards markets to lock in a given exchange rate over a selected period, helping to manage the risk of unforeseen currency swings. However, a currency hedge involves a cost and this cost can fluctuate over time due to a variety of factors.*

Figure 3 shows the relative value of Treasuries including hedging costs for Japanese investors. In late 2017, increasing hedging costs meant that Treasuries were less attractive to Japanese investors relative to buying Japanese government bonds.

*Futures and forward trading is speculative, includes a high degree of risk, and may not be suitable for all investors. The fast price swings in currencies can result in significant volatility in an investor's holdings.

3 EVEN FACTORING IN HEDGING COSTS, TREASURIES REMAIN ATTRACTIVE TO JAPANESE INVESTORS



Source: LPL Research, Bloomberg 05/07/18

Past performance is no guarantee of future results.

Hedge-adjusted yield is calculated by taking the annualized percentage difference between the current exchange rate and the 3-month forward prices of Japanese yen, and the U.S. dollar currency pair, added to the 10-year Treasury yield.

The sharp rise in yields thus far in 2018 has altered the landscape, and once again made Treasuries more attractive for Japanese investors (even including hedging costs), considering the near-zero percent yield of a 10-year Japanese government bond.

CONCLUSION

Trade tensions with China remain a heightened risk for markets globally. With both sides looking for leverage, the prospect of China selling Treasuries (or at least threatening to) has grabbed headlines. We believe China is unlikely to pursue this course on a large scale, however, due to the damage it would do to its own economy, currency, and financial markets. ■

RES 65624 0518 | For Client Use | Tracking #1-728337 (Exp. 05/19)