SPECIAL FX

BROWN BROTHERS HARRIMAN

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Why I am Not Worried About China Selling Treasuries and You Shouldn't be Either

A Real Pig's Eye

The end is nigh. The irresistible force encountered the immovable object. We learned this week that China reduced its Treasury holdings in December for the second consecutive month. Is it really true, as one analyst was quoted on the front page of the Financial Times claiming that China was "saturated" with US paper? Is this yet another nail in the coffin of America's hegemony? Don't bet on it.

The exaggeration here is simply breath-taking. The lead of the Financial Times story is very revealing. "Foreign demand for US Treasury bonds fell by a record amount in December…" In a pig's eye it did. Foreign investors bought a robust $70 bln of Treasury notes and bonds. That is roughly a quarter higher than the 6-month average.

The alarmist journalist is right only in a very narrow sense that the net purchases of Treasury notes and bonds were even stronger in November. At nearly $118 bln worth of Treasuries snapped up by foreigners in November, it is the month that is the outlier, not December.
For the record, foreign investors bought $538.5 bln of US Treasury notes and bonds last year. That is more than a 70% increase from 2008. Indeed, foreign investors bought more US Treasury notes and bonds last year than they did in 2007 and 2008 combined (~$513 bln). You won't see that on the front page of the Financial Times.

What is China Doing?

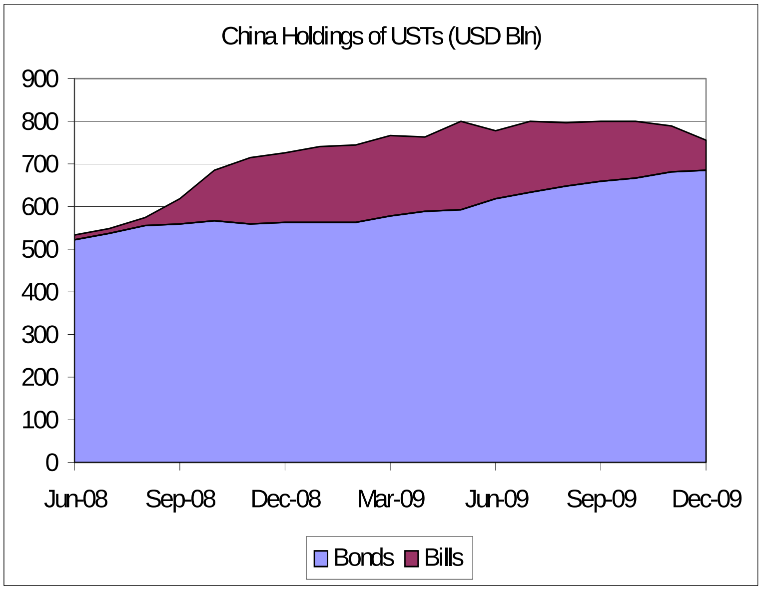
The data is clear. China sold a little more than $34 bln of Treasuries in December. This brought its holdings down to $755.4 bln, which meant that it slipped behind Japan as the largest foreign holder of Treasuries for the first time since August 2008.

The "China is saturated" hypothesis is one explanation. China has had its fill of US Treasuries. Maybe it no longer has an appetite for US securities as a whole. It has been a net seller of US assets for the fifth consecutive month in December.

There is another explanation and it is superior because it can account for more of the agreed upon facts.

Rather than focus exclusively on recent data points of a volatile time series for only part of the Treasury market, a rival hypothesis seeks a broader context. At the same time it recognizes that Chinese activity in US Treasuries dominates its overall portfolio inflows into the US.

An alternative hypothesis would begin when the financial crisis became acute in late September 2008. Between September 2008 and January 2009, China purchased $155 bln of Treasury bills. Remember the whole world was flocking to the US government bill market in what was the mother of all flights to safety. During that period China bought less than $10 bln of Treasury bonds and notes.



Source: US Treasury and BBH

As the crisis eased, investors, American as well as foreign, lengthened maturities. China was no exception. In the June-December 2009 period, China appeared to have allowed $142 bln worth of bills to mature. Roughly 2/3 of the funds were re-invested in Treasury notes and bonds.

That 2/3 figure is interesting too because that is roughly the proportion of Chinese reserves that are believed to be held in dollars. This in turn suggests that the failure to roll-over the full amount may not be nefarious.

Bounded Knowledge

It is difficult to say very much about China's currency reserves because unlike most countries it does not reveal the composition directly, say like the Bank of Canada, or as part of a larger and much more discrete presentation, as the IMF's COFER data provides.

Moreover, because of this more secretive approach to its reserve composition, coupled with a host of other considerations, China is not likely to patronize the Federal Reserve's custodial services. That means that the weekly report of the Fed's holdings of Treasuries for foreign official accounts will not be picking up Chinese flows.

Marc Chandler	212.493.8800
Win Thin	212.493.8361
Meg Browne	212.493.8744
Audrey Childe-Freeman	44.207.614.8791

The Treasury's International Capital (TIC) report is helpful, but its limitations are often not appreciated by officials, reporters or analysts. The most significant limitation is that the Treasury can only collect such data where it has some jurisdiction. A US entity has to be involved. The TIC data tracks bills on a custodial basis and follows the notes and bonds on a transactional basis.

There are many activities that TIC data will not pick up. For example, if China began buying more of its Treasury bonds and notes from a non-American bank, perhaps for no bigger reason than their favorite salesperson changed employers, it may slip through the TIC reports sieve. Or, China may chose to encourage the development of local custodial expertise at Chinese banks, who themselves may transact with some non-US banks and use a non-US sub-custodian, or some combination thereof.

Nevertheless, there is reasonable evidence that some diversification may be taking place. But the kind of diversification may be subtle. The diversification out of Treasuries is not necessarily a diversification out of the dollar. There have been months when China was a net seller of Treasuries but a buyer of other long-term US assets.

China's appetite for dollar denominated fixed income products is part of the reason that European sovereigns and corporates have a full issuing schedule. European sovereigns alone are expected to issue $25 bln of dollar-denominated bonds this year, twice last year's amount.

What China is Not Doing

Many serious people feared that China would use its Treasury holdings as leverage to influence US policy. In the pursuit of national interest, the Obama Administration has done a few things recently that Chinese officials find particularly irksome, like the President's meeting with the Dalai Lama and the recent arms sales to Taiwan, leaving aside the chronic trade friction. There has been some suggestion that China is sending the US a signal. The problem with this hypothesis is that the Chinese sales of Treasuries took place prior to these incidents.

However, if the US Treasury holdings really did give China leverage, then its reduced holdings are the financial equivalent of unilateral arms reduction as it sought no concession. This is not really believable either. China bought long-term US Treasuries for the last ten months of 2009. Some observers feared that "when" China would begin selling off its vast stock of Treasury holdings, US rates would rise. However, a take away point is that the Treasury market is bigger than China; that despite its large holdings, it is still a price taker not giver.

Since the largest drop in Chinese Treasury holdings since at least 2000, what have Treasuries done? They have appreciated. The yield of the 2-year note has fallen about 20 bp and the 10-year yield has slipped a more modest 4 bp and this after the reaction to the Fed's discount rate hike. An index of T-bill yields has risen a few basis points but would have still outperformed nearly any euro denominated instrument when converted back to China's functional currency (either the dollar or yuan).

China did not buy the IMF's gold because the price was too high. The sudden decline in the euro now, like in the second half of 2008, complicates the task of the PBOC. Diversifying away from the dollar does not look as easy of a call as many had claimed.
Indeed, those more moderate forces within China, who recognize that the US is only a "sick camel" not a "dead horse", to borrow some imagery from Chinese sayings, are likely to have been strengthened by recent developments.

Now you too can sleep at ease, knowing that China reduced its Treasury (bill) holdings and we did not notice the difference. Letting bills mature and rolling a good chunk into the longer end of the US Treasury curve was conducted in a most unobtrusive fashion and was easily absorbed by the market. It appears to be a perfectly normal operation. When looking into the face of a global financial meltdown, China did the same thing as other investors: flocked to the safety of US T bills. The unwinding of these operations does not have long-term implications of China's appetite for dollar denominated securities in general and US Treasuries in particular.

Good night.

Marc Chandler
Global Head of Currency Strategy

Marc Chandler	212-493-8800
Win Thin	212 493-8361
Meg Browne	212-493-8744
Audrey Childe-Freeman	44 207 614 8791