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The “Technical” Case for U.S. Treasuries

Has the recent government shutdown, years of failed attempts to balance our nation's budget, and recent resistance to increase the Treasury debt ceiling increased political risk for global investors that own half of U.S. debt obligations? Has our dysfunctional political system shaken the world’s unwavering faith in the U.S. bond market or the status of the “greenback” as the premier currency reserve? Presently, the U.S. dollar remains the benchmark for pricing global commodities and the U.S. Treasury remains the benchmark for all global fixed income investors. This article briefly identifies and provides insight into the primary factors determining the relative value of U.S. Treasuries on the global stage.

Pundits claim that recent periods of budget deficits, mounting national debt, and political impasses related to the debt-ceiling will eventually drive global investors away from Treasuries and the U.S. dollar will someday lose its currency reserve status. The results of such a move would be catastrophic to our economy and could result in spiraling inflation and high interest rates. From a fundamental perspective, the inflation argument is sound; however, technical drivers often determine the outcome of prices. Technicals can explain the level of bond yields in today’s Treasury market. Global excess reserves, chronic trade imbalances, global stagnant-to-slow economic growth and low interest rates in developed nations have led foreigners to continue buying dollars and supporting the U.S. Treasury market regardless of actions (or inactions) taken by U.S. policymakers and political leaders.

Global Excess Reserves - According to 2012 data from the World Bank, only 15 countries hold 75% of the world's total excess reserves. Surprising to some, China holds the top spot, followed by Japan, Saudi Arabia, the United States, and Russia, holding 27.4%, 10.3%, 5.4%, 4.6%, and 4.3% of the world's excess reserve, respectively.

Of those top 15 countries, only five of them have "developed" and "openly-tradable" bond markets. The largest, most liquid bond market for foreign ownership is clearly the U.S. Treasury market. According to the Barclays Global Treasury Index, as of December 31, the Japanese government bond market ranks as the largest in total value, modestly greater than the U.S. Treasury market. However, when you consider that 90% of the Japanese bond market is held domestically by its corporations and citizens, the “tradable” Japanese bond market is much smaller. Euro-Zone bond markets, in aggregate market value, are comparable to the U.S. Treasury market; however, bonds are backed by single country sovereign governments. Not only are global investors faced with single country credit risk, but also smaller markets that are less liquid. As for China, Saudi Arabia, and Russia, their bond markets are "emerging" and are not practical for global investors. Therefore, the U.S. Treasury market naturally benefits from foreign investment of excess reserves. As of October 2013, foreigners held 56.1% of the $10.1 trillion U.S. Treasury public debt available.[1]

Foreign Holders of U.S. Treasuries

Countries	*Holdings (Billions)*	*Ownership (%)*
China	$1,304.5	23.0%
Japan	1,174.4	20.8%
Caribbean (Off-Shore Tax Shelters)	290.7	5.1%
Brazil	246.7	4.4%
Middle East (Oil Exporters)	236.6	4.2%
Taiwan	184.5	3.3%
Belgium	180.3	3.2%
Switzerland	174.3	3.1%
United Kingdom	158.4	2.8%
Russia	149.9	2.7%
All Others	1,553.2	27.4%
Grand Total	**$5,653.5**	**100.0%**

Source: Bloomberg

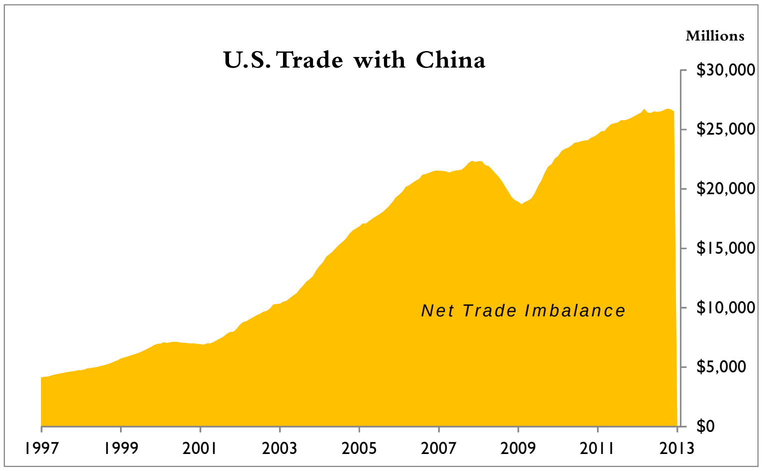
Trade Imbalances - For over twenty years,[2] so-called "Free Trade" agreements between the U.S. and other less-developed nations have significantly increased exports and imports with trading partners. However, when reviewing the U.S. trade figures, imports continue to outpace exports

[1] Treasury Debt Held by the Public of $12.2 trillion less $2.1 trillion held by the Federal Reserve.

[2] NAFTA (North American Free Trade Agreement) was signed in 1992 and was first major agreement to expand international trade.

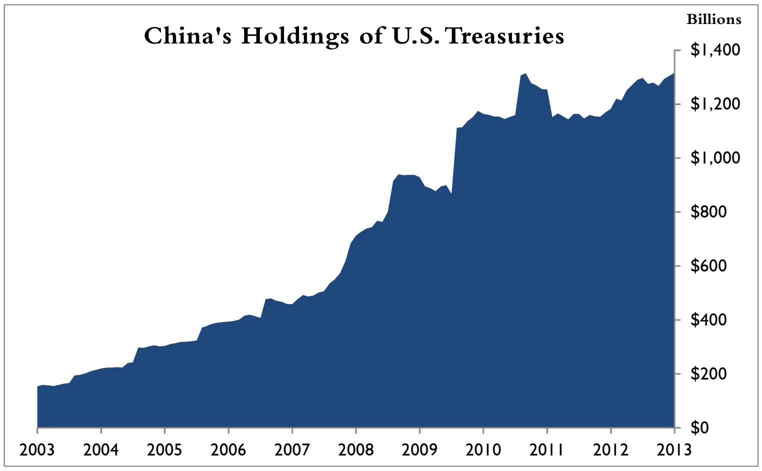
resulting in a trade imbalance. Although the trade balance has benefited the U.S. consumer with lower inflation rates of goods and services it has firmly placed the U.S. economy in the chronic position of being consumption-based. The trade imbalance has inadvertently increased the reserves of export-based economies, such as China, the Middle East, Japan, and Emerging Nations. Just examining the last ten years, the imbalance between foreign-made imports relative to exports has increased dramatically. The imbalance is greatest with our largest trading partner, China, and represents nearly 50 percent of the trade imbalance.

Furthermore, the trade imbalance with China has accelerated based on increased growth rates of imports relative to exports. Over the most recently reported 12 month period, the net export of dollars for purchases of Chinese-made goods and services was $318 billion. This is a 12% increase from the five year annualized average rate of $285 billion. Over the last five years, China has received $1.424 trillion in net U.S. dollars from the trading imbalance. Ironically, this amount is similar to the $1.3 trillion in Treasuries presently held by the People's Bank of China.[3]



Source: Bloomberg

Based on the constant flow of dollars paid for the "Made in China" goods and service, the only option for the decade long tidal wave of import payments and profits is to re-invest back into dollar-denominated Treasuries. The People's Bank of China has no other option but to support the U.S. Treasury market, regardless of actions taken by our political leaders.



Source: Bloomberg

Low Interest Rates Globally - Finally, interest rates across the globe are historically low. Central banks throughout the G-10[4] have been engaged in long-term accommodative monetary policies to stimulate their slow economic growth rates. Despite steps taken thus far (according to a composite of economists contributing their forecasts to Bloomberg) the global economic growth and inflation rates are forecasted to only be 2.9% and 2.7%, respectively, for 2014. However, when faster growth regions of Asia are removed, economic growth and inflation rates are even lower and forecasted to only be 2.1% and 1.6%, respectively. Although, growth rates and inflation are much improved from the global recession in 2008-2009, present rates are still lower than long term trends. As a result, interest rates remain low across all developed markets.

The 10 year U.S. Treasury yield ended the year at 3.03%, which appears very unattractive based on historical averages. However, 10 year bonds issued by other developed nations are not much higher than the U.S. In fact, fourteen other developed nations have 10 year bond issues that **actually yield lower than** the U.S. Treasury. Japan leads the globe with the lowest 10 year bond yield paying a paltry .64%, followed by Switzerland, Germany, Denmark, and Finland, paying only 1.22%, 1.94%, 1.97% and 2.12%, respectively. In Asia, in addition to Japan, 10 year bonds issued by Hong Kong and Singapore pay only 2.33% and 2.57%, respectively. At 3.0%, compared with other bond alternatives, U.S. Treasuries look reasonably attractive and will encourage foreign investors to continue to favor placing their savings under the U.S.-backed mattress.

[3] People's Bank of China is the central bank of the Republic of China.
[4] G-10 is the Group of Ten - developed nations from North America, Europe and Asia.