China has stepped up its purchases in the U.S. treasury market – that despite tensions and expectations that the country would pull back. "The Chinese government has increased its buying of U.S. Treasury this year at the fastest pace since records began more than three decades ago, data released Wednesday show," reports Min Zeng for the Wall Street Journal. "The buying has been fueled by China's efforts to lift its export-driven economy by weakening its currency, the yuan, against the dollar, market analysts said, a strategy that encompasses hefty purchases of U.S. assets." China holds 10 percent of the $12 trillion treasury market debt, the article notes, and China's $4 trillion in foreign-exchange reserves is the largest in the world. Short-term consequences include weakening the yuan against the dollar, a boost for China's export markets but also stoking inflation, while keeping interest rates low for the United States, which encourages consumption. US spending is increasingly dependent on China's purchases; the country's influence over the treasury market is immense. Analysts have urged gradual slowing of the dangerous mutual dependency. An abrupt end to Chinese purchases or a rapid rise in US interest rates could destabilize both nations and the global economy. – YaleGlobal

Analysts are scratching their heads: Record Chinese purchases of US treasuries help explain US bond rally, encourage dangerous US spending and dependency
Min Zeng
The Wall Street Journal
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Investors wrestling with the mysterious U.S. bond rally of 2014 got a clue about where to look: China.

The Chinese government has increased its buying of U.S. Treasurys this year at the fastest pace since records began more than three decades ago, data released Wednesday show. The purchases help explain Treasurys' unexpectedly strong rally this year. The yield on the 10-year U.S. Treasury note has fallen to 2.54%, from 3% at the end of 2013. Yields fall as prices rise.

The world's most-populous nation boosted its official holdings of Treasury debt maturing in more than a year by $107.21 billion in the first five months of 2014, according to the U.S. government data. The buying has been fueled by China's efforts to lift its export-driven economy by weakening its currency, the yuan, against the dollar, market analysts said, a strategy that encompasses hefty purchases of U.S. assets.

China officially holds roughly $1.27 trillion of U.S. debt, about 10.6% of the $12 trillion U.S. Treasury market.

The country's purchases have salutary effects on both sides of the Pacific. In addition to the weaker yuan in China, they hold down U.S. interest rates, making houses more affordable and generally easing financial conditions in the U.S. economy.

On the other hand, lower yields mean lower income for bond investors. They have spurred investors to chase assets globally for returns, fueling asset-price increases and investor fears that some market valuations are stretched.

Also, investors fear any reduction in Chinese purchases, along with other macroeconomic events, could destabilize the U.S. bond market and send rates higher, slowing the housing industry, widely viewed as a key driver of economic growth. Some analysts contend that low rates also can allow capital to be misallocated, fueling the risk of future economic disruption.

In a bid to boost returns, China has sought to diversify its foreign-exchange holdings away from U.S. government bonds in recent years. But it finds itself having to keep purchasing the U.S. debt due to a lack of investment choices elsewhere. "There is no other market that is as liquid and deep as the U.S. Treasury market," an official at China's central bank said in a recent interview.
China’s aggressive purchases of dollar assets also present the authorities with problems at home. That is because the purchases cause the money supply to expand and can fuel inflation within China unless the central bank soaks up the excess liquidity injected into the system.

The bond rally has left many traders on Wall Street scratching their heads. Most investors had forecast that interest rates would rise this year as the U.S. economy picked up steam and the Federal Reserve slowly pared its stimulus measures, in a shift that was widely expected to push rates higher.

But yields remain far below 2013 highs even as U.S. job creation has gained pace in recent months. The disclosure of China’s holdings underscores the frayed nerves in the bond market as the Fed prepares to raise interest rates as early as next year, for the first time since the financial crisis. Many investors fear that reduced Fed support and unpredictable buying by foreign governments could spell bond-market tumult.

"The big picture is that China buying may be helping to keep bond yields lower than they should be ahead of the Fed moving closer to raising rates," said Chris Rupkey, chief financial economist at Bank of Tokyo-Mitsubishi UFJ. "The market could wake up and get quite a shock...if China changes course." The risk for the U.S. economy, said Mr. Rupkey, is that any slowdown in Chinese purchases could push U.S. bond and mortgage rates higher, which would put "the fragile housing recovery in jeopardy."

At the same time, many investors over the past decade have warned of the risks of reduced purchases from China precipitating a U.S. interest-rate spike—predictions that haven't been borne out.

The rise in China’s Treasury holdings disclosed Wednesday marks the biggest first-five-month increase since record keeping began in 1977 and surpasses the $81 billion of Treasury debt bought by China for all of 2013, according to Ian Lyngen, senior government-bond strategist at CRT Capital Group LLC.

China has increased its U.S. Treasury holdings every year since the 2008 financial crisis except for 2011. China continued to log a trade surplus with the U.S., thanks to its aggressive efforts to boost exports over the past decade. That has led to a huge accumulation of foreign-exchange reserves, and the Treasury market is the most liquid bond market for China to invest reserves, analysts said.

China held $1.2633 trillion in notes and bonds at the end of May, compared with $1.156 trillion at the end of 2013, according to Jeffrey Young, U.S. rates strategist at Nomura Securities International in New York.

The gain reflects in part China’s decision to shift its U.S. investments to longer-term securities from short-term debt known as bills. Including bills, which mature in a year or less, China held $1.2709 trillion of Treasury debt at the end of May, compared with $1.2700 trillion at the end of December 2013, according to the latest data from the Treasury Department.

Analysts have long cautioned that the Treasury report isn’t a complete picture because it doesn't account for China's holdings at third-party custody institutions in other nations, such as the U.K. and Belgium.

China's foreign-exchange regulator, the State Administration of Foreign Exchange, didn't immediately respond to a faxed request for comment.

China's purchases come as U.S. issuance slows, amid higher tax receipts from an improving economy. Mr. Young at Nomura Securities International estimated that net supply of Treasury notes and bonds this year would be $650 billion to $690 billion, down from $836 billion last year and $1.565 trillion in 2010.

The Fed has been dialing back its monthly purchases as well. Mr. Young said the central bank's buying this year would account for about 38.5% of net Treasury issuance, down from 65% last year.

China hasn't been the only big buyer this year. Japan, the second-largest foreign owner of Treasury bonds, increased its note and bond Holdings by $9.56 billion during the first five months of the year. Including bills, Japan's holdings of Treasury debt was $1.2201 trillion.

China's foreign-exchange reserves currently approach $4 trillion, the world's biggest in size. China doesn't disclose the composition of the reserves, but analysts say most are denominated in U.S. dollars. This year, China has taken actions to weaken its local currency to make its exports cheaper. When China sold the yuan, it bought the U.S. dollar, and analysts said China likely often used the proceeds to purchase more Treasury debt.
"China will continue to buy Treasury bonds as long as they want to keep the yuan's value lower to support exports," said Peter Morici, professor at the Robert H. Smith School of Business at the University of Maryland. "I don't think China will pull away from the Treasury bond market even if the Fed raises interest rates."

Christopher Sullivan, who oversees $2.35 billion as chief investment officer at the United Nations Federal Credit Union in New York, added that "China's investment in Treasury bonds is mostly trade driven and not opportunistic," like hedge funds or other bond traders.

U.S. bonds yield more than Germany's, which are at 1.2%, and Japan's, at 0.54%....

Some investors caution that higher-yield forecasts may not pan out. China's buying will be "a restraint on yields," said Mr. Sullivan. "I think 3% is highly suspect for 2014."

Lingling Wei contributed to this article.

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