PERSPECTIVES

CHINA, THE GOLIATH OF THE TREASURY MARKET

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After the latest round of the trade war, China has imposed tariffs on nearly all of the $130 billion in annual goods imports from the U.S. Though China could increase the tariff rate, they have effectively spent all their ammunition in terms of the scope of tariff application. As China-watchers have speculated as to what other tools the Communist Party may bring to bear, the financial press has offered the usual incendiary headlines warning that sales of China's vast Treasury holdings could cause a volatile repricing of Treasury yields.

We're skeptical of this threat for two reasons. First, Treasury sales would cause the yuan to appreciate against the dollar, all else equal, which would reduce demand for Chinese exports and slow overall economic growth. Much has been made of China's long-term transition from export and investment to a consumer-driven growth model, but limited progress has been made thus far and exports still

account for 20% of Chinese GDP. The Chinese economic policymaking process is difficult to predict, but at the very least, Party leadership would have to balance the domestic cost of slower export growth against the perceived benefit from Treasury sales as a trade war tactic. The fact that Chinese authorities have allowed the onshore yuan to depreciate by 9% since the trade war heated up in February suggests domestic growth is the priority for now.

Second, while China is indeed the single largest foreign holder of Treasuries, their $1.2 trillion portfolio is in fact not outsized relative to the overall market and other large investors. Chief among these is the Fed, which owns $2.3 trillion in Treasuries. In the event that China surprised the market with a disorderly Treasury selling program, U.S. financial conditions would likely tighten in the form of higher yields and perhaps lower risk asset prices. The Fed could respond with dovish communications or a pause in rate hikes that could easily offset the yield impact of Chinese sales. Recall the August 2015 yuan devaluation that sparked a 10% decline in the S&P 500 and weakened the global growth outlook so much that the Fed deferred rate hikes for the first three quarters of 2016. The subsequent flight-to-quality response and repricing of the Fed path saw the 10-year Treasury yield decline 75 bps to an all-time low of 1.36% in the summer of 2016. In the extreme, the Fed could reverse the current policy of balance sheet runoff to offset the financial conditions impact of Chinese sales. The Fed is currently shrinking the balance sheet by about $400 billion per year. China's total holdings are therefore just 3 years' worth of Fed runoff.

Another large investor base that would likely step in to buy Treasuries if yields increase is near and dear to NISA's heart, namely pensions. Corporate DB Plans, in aggregate, probably own about $400 billion in Treasuries today (in addition to $700 billion in credit). According to our rough estimation of glidepath de-risking behavior for the entire industry, every 5% increase in funded status creates potential demand for about $140 billion in Treasuries (and $200 billion in credit). As corporate DB Plans gradually move toward an end state of 105% funded, they could potentially demand an additional $400-600 billion in Treasury securities. Though obviously funded status is also a function of risk asset returns, if Chinese Treasury sales drove up the level of yields, we would expect that rise to be contained by an influx of demand from pensions.

From NISA's perspective, if China tries to unload their Treasuries, they're unlikely to find a shortage of willing buyers. Though China is often presented as a giant of the Treasury market, they may turn out to be Goliath if they ever try to sell. One well-aimed sling shot from the Fed could quickly negate any effect.

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