



TD Economics

Special Report

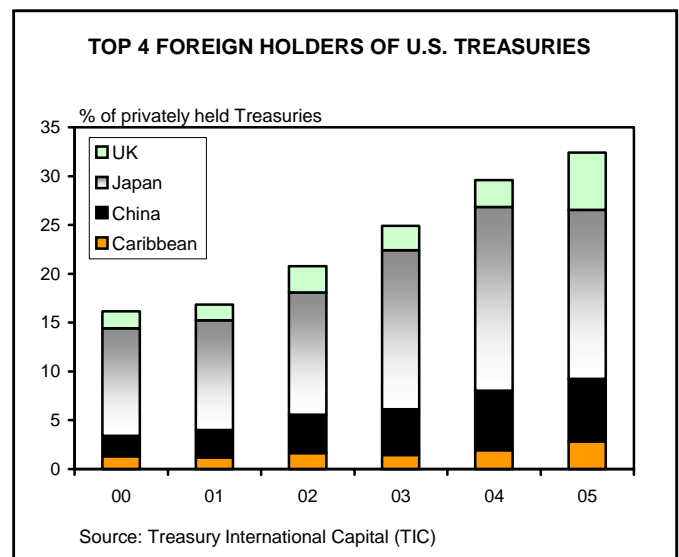
April 3, 2006

WILL U.S. TREASURIES PAY A PRICE FOR RECORD FOREIGN INDEBTEDNESS?

There have been many theories put forth to explain Greenspan's conundrum of low long-term Treasury yields, including well-anchored inflation expectations and rising pension fund demand. In this paper, we explore one of the more politically sensitive variables – increased foreign demand for U.S. Treasuries. Foreigners own just over one-quarter of all U.S. Treasuries. However, this understates the magnitude of offshore holdings. Stripping away Treasuries held by the Federal Reserve and domestic government accounts, the foreign portion of private holdings is over 50 per cent, or US\$2.2 trillion. There is little doubt that intensified foreign demand for Treasuries has helped pin down long-term bond yields, but there is some question over the degree to which it will continue to do so in coming years. Aggressive foreign central bank buying was a major catalyst for lower yields in the 2001-2004 period, but net purchases leveled off in 2005. In addition, much-improved domestic economic conditions in Japan – the dominant foreign holder of U.S. debt – may blunt future purchases or even prompt the central bank to scale back existing holdings. Lastly, the recent shift from central bank accumulation to the private sector leaves Treasury yields more vulnerable to market sentiment and cyclical fluctuations, particularly within the four dominant regions of Japan, China, the United Kingdom, and the Caribbean, which own 1/3 of all privately-held U.S. Treasuries (double the portion held at the start of the decade).

Foreign exchange movements at the heart of Treasury purchases

After nearly two decades of relative stability in net purchases, buying spiked in the mid-1990s, especially in 1997 and 1998 when investors fled to Treasuries for safety



during the Russian debt default and Asian financial crisis. Net Treasury transactions subsequently cooled, as equities became the security of choice during the tech boom. But, bonds were back in favour by 2002 and have since held that position. Aside from the fact that foreigners show a willingness to trade-off between corporate equity and Treasuries, the preference for debt holdings in 2002 coincided with a sharp depreciation in the U.S. dollar. This latter aspect is of particular interest because a large number of Treasury purchases were the by-product of currency intervention by China and Japan, and a change in policy within these two countries (even a relatively minor one) can have serious implications for Treasury yields.

Bank of Japan may not try to fend off future bullish sentiment

Central banks stepped up Treasury buying in 2002 and

again in early 2004, and it's no secret that the two largest holders are Japan and China. In particular, Japan's Treasury holdings more than doubled between 2002 and 2004 – a period when the U.S. dollar lost 28 per cent of its value with its major trading partners.

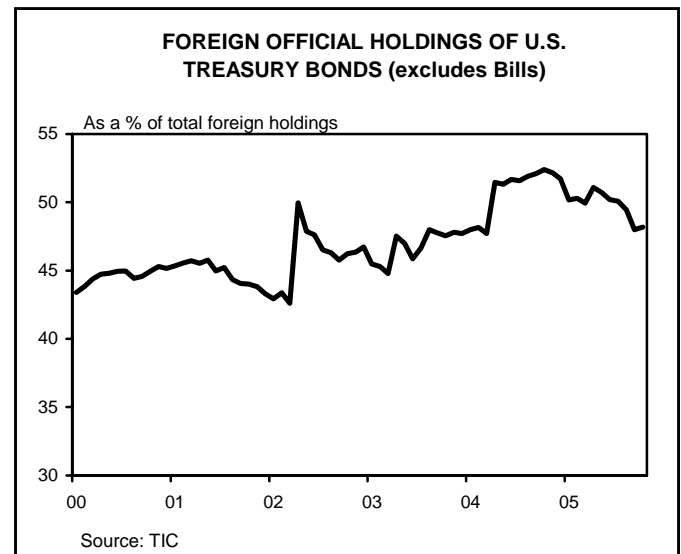
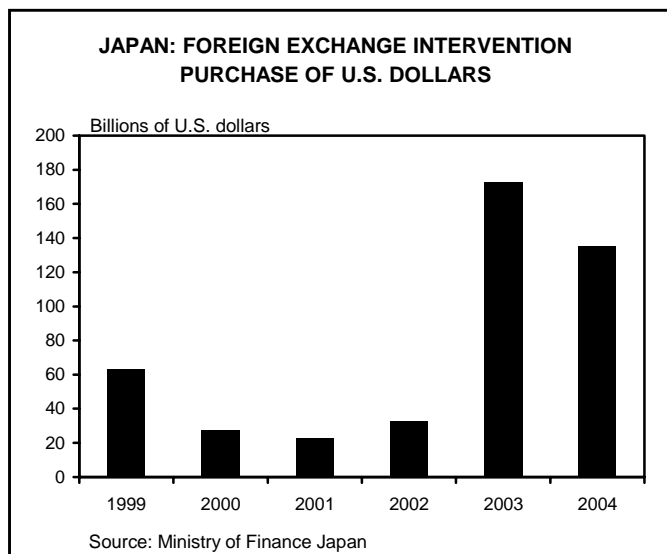
Against a rising tide, Japan tried to fend off bullish investor sentiment towards the yen in an effort to maintain external competitiveness, boost exports and attract foreign direct investment. From 2003 to 2004, the Bank of Japan (BoJ) purchased the equivalent of US\$308 billion through foreign exchange intervention operations. This was more than twice the combined purchases in the four years prior. In turn, Treasuries offered a convenient way to recycle those U.S. dollars. Between 2002 and 2004, the yen did underperform relative to other major currencies with the greenback, but the Japanese currency still posted a 20 per cent gain. This was a blatant reminder that the fight against market sentiment was merely serving to deplete the BoJ's foreign exchange reserves with only slight consequence to the exchange rate.

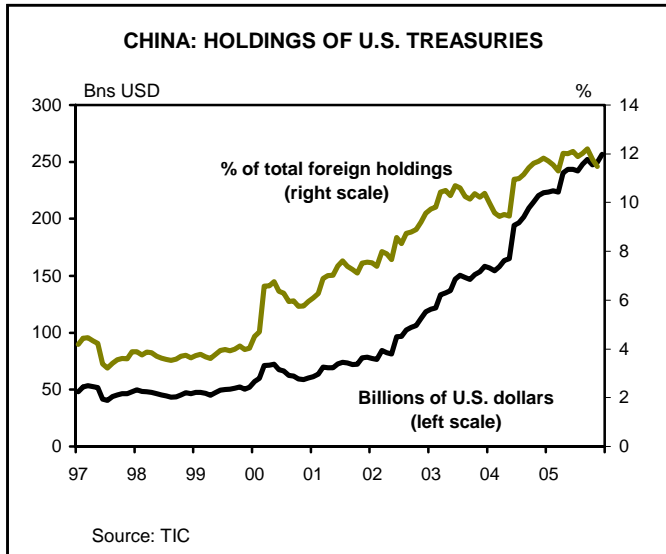
The BoJ abandoned this strategy in 2005, as there is no evidence of foreign exchange intervention in that year and overall Treasury holdings were scaled back by US\$5 billion. However, it is too early to tell whether the central bank has adopted a new approach or whether this was a product of market forces. The U.S. dollar returned to the good-books of international investors in 2005, appreciating about 12 per cent against the yen. This automatically took pressure off the BoJ to intervene in currency markets.

Nevertheless, there is some question as to whether the BoJ will have the same voracious appetite for Treasuries if (and when) downward pressure resumes on the greenback. Over the 2002-2004 period, Japan was still fighting deflation and lackluster domestic demand. The BoJ simply could not afford erosion in its trade competitive position, due to reliance on export-led growth. But, 2005 was a watershed year. Convincing evidence emerged that deflation was drawing to a close, while firming domestic demand started to play a key role in driving economic growth. With the economic recovery no longer as fragile as it used to be, the threat from a gradual or orderly appreciation of the yen is also greatly reduced. As such, the BoJ may be less willing to intervene in currency markets next time around – especially under a rising tide of international political pressure. If history ends up showing that 2005 was a concerted effort by Japan to diversify away from Treasuries, a key source of downward demand pressure on yields will have been sidelined.

China's slow and steady approach

The story for China is an extreme version of that for Japan. Although Japan tried to "manage" its currency, the yen is free floating and the level is ultimately determined within global foreign exchange markets. In contrast, the Chinese yuan was strictly pegged to the U.S. dollar until mid-2005, requiring the central bank to intervene in foreign exchange markets on a daily basis to prevent an increase in the currency. In turn, the central bank would purchase Treasuries with the U.S. dollars it had accumu-





lated via currency market intervention, as well as through trade and investment flows. Between 2000 and 2005, China more than tripled its holdings of Treasuries from \$60 billion to \$257 billion. By comparison, over the entire seven-year period between 1994 and 2000, China beefed up Treasury ownership by only \$58 billion.

Recently, China has implemented steps to lessen its dependence on the greenback, though the yuan continues to trade within a narrow and tight range. In July of last year, China announced that the yuan would be tied to a weighted basket of currencies, rather than just the U.S. dollar. The yuan would also be permitted to appreciate 2 per cent and move 0.3 per cent in either direction each day. Although the cumulative impact could be significant over time, in practice the yuan has appreciated less than 3 per cent since the policy was implemented – implying that currency intervention and Treasury purchases remain significant. In January of this year, the Chinese government started to mull over the prospects of diversifying the composition of its currency reserves, which are disproportionately held in the greenback.

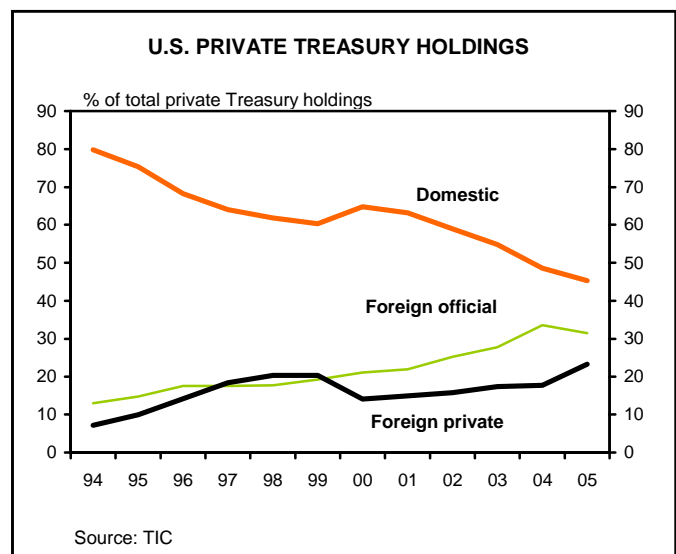
Only time will tell if these announcements have a material impact on the U.S. dollar (and hence Treasuries). In the near-term, the scope seems limited, as China would not want to undermine economic and financial stability simply to divest from U.S. dollars. However, political pressure is building and there is no denying that a deliberate effort is underway towards a more open and integrated financial market system. Progress will be slow, but China's recent announcements support the notion that Treas-

ury accumulation will, at the very least, taper off from the red-hot pace of yesteryears.

Third-party purchases suspected

Since central bank foreign holdings tend to be rather stable over time, any shift away from U.S. Treasuries by either Japan or China would be a long, drawn out process. While this may cause long yields to gradually drift higher over the next couple of years, it is unlikely to be a destabilizing influence on Treasury markets. The same, however, cannot be said with confidence for foreign private purchases, which have been increasingly channeled through the U.K. and the Caribbean region. Widening interest rate spreads between the U.S. and other major economies have lured private investors towards Treasuries in the past year. The graph below shows a leveling off in central bank holdings in 2005 was more than offset by a pick-up in foreign private purchases.

Few would have predicted U.K. holdings to have more than tripled in the past five years, to the point where the U.K. now rivals China in its ownership of American debt. The main difference between the two countries, however, is that U.K. holdings rose abruptly in 2005 by US\$133 billion. What's behind their sudden love affair with Treasuries? Probably just accounting principles. The U.S. Department of Treasury records inter-country security transactions within the country where the foreign buyers and sellers deal **directly** with entities in America. Therefore, the data do not necessarily indicate which country is the final owner of the debt product. For example, a pur-



chase of U.S. securities by a German investor that is placed directly with an intermediary in London, ends up being recorded as a U.K. transaction. Given that London is an international hub with a strong presence in foreign exchange markets, it's more probable that the spike in U.K. purchases in 2005 reflected third party purchases, rather than a sudden desire to amass U.S. assets. In particular, London acts as a conduit for petrodollars – revenue derived from oil sales – for Middle Eastern countries. Soaring oil prices have accelerated oil export revenues in the Middle East, outstripping those of the 1970s and early 1980s. Flush with petro-dollars, these oil exporting countries have recycled them into the U.S. bond market (one analyst estimated that it could be as much as US\$115 billion in 2005).

This raises two significant upside risks to Treasury yields. First, the greenback rally in 2005 has probably topped out, raising the odds that Arab kingdoms will turn into sellers of U.S. Treasuries in 2006 or coming years. Second, a drop in oil prices from a global economic slowdown would also pressure Treasury yields higher, due to the recycling of fewer petro-dollars. Of course, the impact on Treasuries could be compounded if both of these factors happened simultaneously.

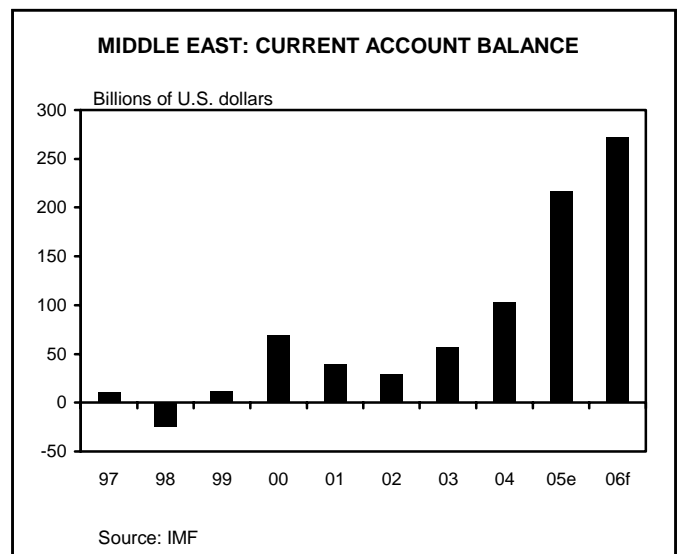
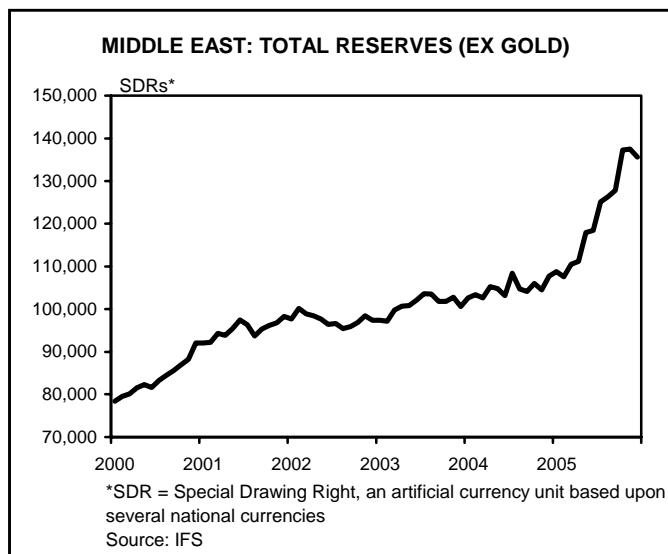
The Caribbean: not just a place for a great tan

Treasury purchases via the Caribbean are reflecting a similar phenomenon. However, in this instance, the recycling of petro-dollars is probably not the dominant player. Though the Caribbean is a much smaller international

player, it grabs 4th spot with US\$111 billion in Treasury holdings. However, like the U.K., purchases increased only recently, with \$63 billion of these Treasuries accumulated in 2004 and 2005. The Caribbean region is home to a number of hedge funds and financial intermediaries due to its 'tax haven' status. And, Japan certainly makes use of the Caribbean islands for more than just its white beaches and blazing sun. Japanese net purchases of all bonds (U.S. and other countries) in the Grand Cayman Islands totaled 5.5 trillion yen in 2004 (the equivalent of US\$47.3 billion). This was more than double the purchases that occurred in each of the five years prior. And, it's no secret that Japanese investment capital going to the Caribbean is redirected into the U.S. and European investment markets. The good news is that if Caribbean purchases are indeed skewed towards Japanese buyers, this may actually mitigate the risk to Treasury yields. It's possible that private purchases are being overestimated (likewise, central bank buying is being underestimated) if BoJ purchases are being routed through this financial intermediary. However, once again, time will be the measure of risk.

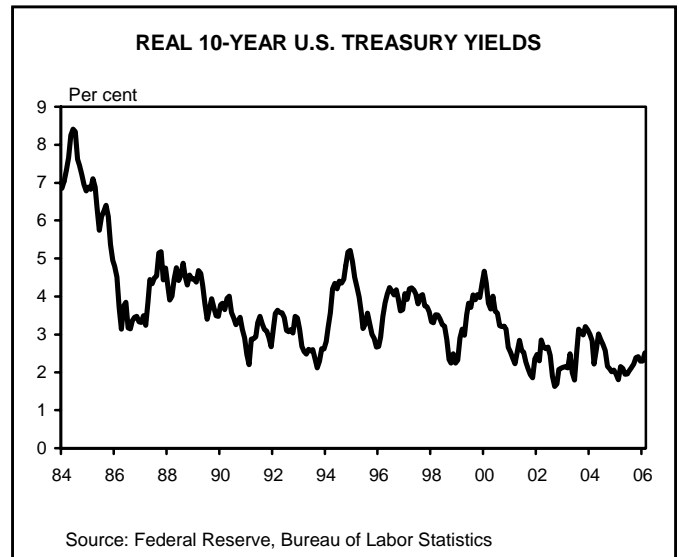
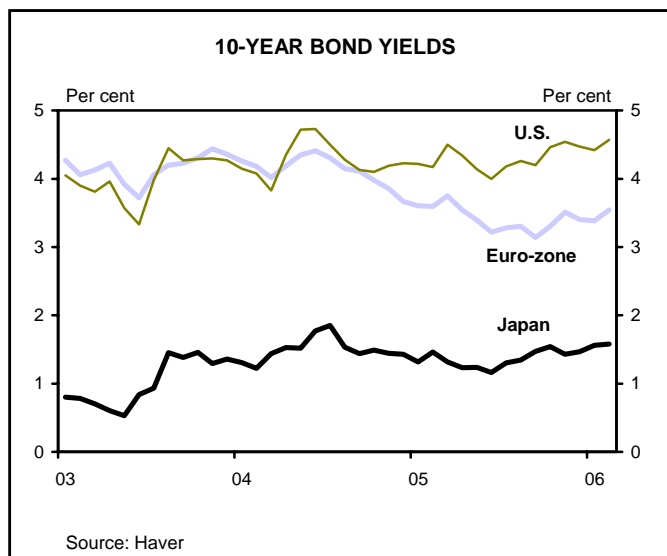
Is there a price to pay?

The higher incidence of private purchases leaves U.S. Treasury markets more vulnerable to shifts in market sentiment and cyclical fluctuations. For instance, a meaningful drop in oil prices would reduce Treasury purchases from recycled petro-dollars. Likewise, private investors are far more sensitive to capital losses should the relative



yield spread advantage of U.S. Treasuries erode against other major regions. And, there is a good chance this will occur, as the Federal Reserve's tightening cycle nears an end. The European Central Bank has only just begun a tightening cycle and the Bank of Japan is contemplating the same. 10-year Treasury yields were hemmed in a range of 4.0-4.7 per cent over the past year, and while this is considerably higher than what was offered by its counterparts in the Eurozone and Japan (3.50 per cent and 1.50 per cent, respectively), the outsize yield advantage will narrow.

This is not to say that long yields will revisit past levels of 6 per cent or more. To date, American bonds are not paying a big price for heavy foreign indebtedness. One reason lies in the fact that the greenback is the reserve currency of the world, and this keeps an informal floor under demand for dollar-dominated assets. To give an idea of this theory in practice, two-thirds of allotted foreign exchange reserves in the world are held in U.S. dollars, and this ratio has been steadily rising since the start of the decade. Treasuries have the added benefit of home field advantage. Foreign investors maintain a keen preference for U.S. financial assets because those markets are the deepest in the world – a status that will not be suddenly usurped. Other longer term fundamental factors are also at play. For instance, a sharp reduction in economic and inflation volatility over the past decade has anchored inflation expectations, thereby lowering the term premiums demanded by investors (for a detailed discussion see Global Markets lead article, January 2006). Accordingly, inflation-adjusted



bond yields have been on a gradual declining trend over the past two decades. Given that this is a structural movement, downward pressure on yields from this source is here to stay.

Treasuries not home-free just yet

But, Treasury markets are unlikely to completely skirt retribution for high foreign indebtedness. One need only look to the relative yield performance between Canadian and U.S. bonds for confirmation of this. The 10-year Canada-U.S. yield spread has been negative since February 2005. This is somewhat of a rare occurrence and is currently largely justified on lower Canadian short-rates and the market expectation for that to remain the case, at least in the near-term. However, in addition to this, a price has been exacted on Treasuries due to structural differences between the two countries. Canada's superior fiscal health has blunted required long-term bond issuances, while the opposite is true under ballooning government financing needs in the U.S. More supply equals higher yields.

What's more, no country or currency is completely immune from investor sentiment, which we know can be fickle. If the shine rubs off the U.S. economy and private investors and central banks decide to diversify away from the U.S. dollar and related assets, it wouldn't take much for Treasury yields to head higher. To be clear, Japan and China would not suddenly decide to dump Treasuries, as this would be extremely destabilizing to their own economies and financial markets. But, with the Japanese

economy gaining traction and with China implementing measures to diversify to other currencies and financial assets, the rapid Treasury accumulation of the 2002-2004 period may be a thing of the past. Second, although Treasury yields have been weighed down by private purchases, this is a tenuous hold given the volatility of market sentiment related to capital loss sensitivity.

Outlook

So what does this mean to the outlook for U.S. bonds? We believe economic cyclical movements will largely determine the direction of yields over the next 12-18 months, but the inherent risks of high foreign ownership certainly do not escape our attention.

In our base-case financial forecast, cooling housing markets and a moderation in consumer spending bring about a U.S. mid-cycle economic slowdown in the second half of 2006 and first half of 2007. This, in turn, is a catalyst for a slight rally in Treasury prices, causing 10-

year yields to pull back towards 4.30 per cent by the end of this year. However, this cyclical driver will run its course and yields will back-up to the 5.05 per cent mark by the end of 2007.

However, we cannot end this discussion without recognizing that America's record reliance on foreign inflows introduces such a high degree of vulnerability to the Treasury market, that it may not take much in terms of an erosion in market sentiment to push Treasury yields above our current prediction. For now, this remains a key risk and not the most probable outcome over our forecast horizon. But, keep an eye out for a substantial improvement in world economic conditions, which could be a tipping point, as tightening global interest rate spreads could lessen the appetite for U.S. debt. Key signals to watch for include significantly stronger economic growth in Europe and Asia, alongside signals from non-American central banks towards a higher interest rate environment.

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