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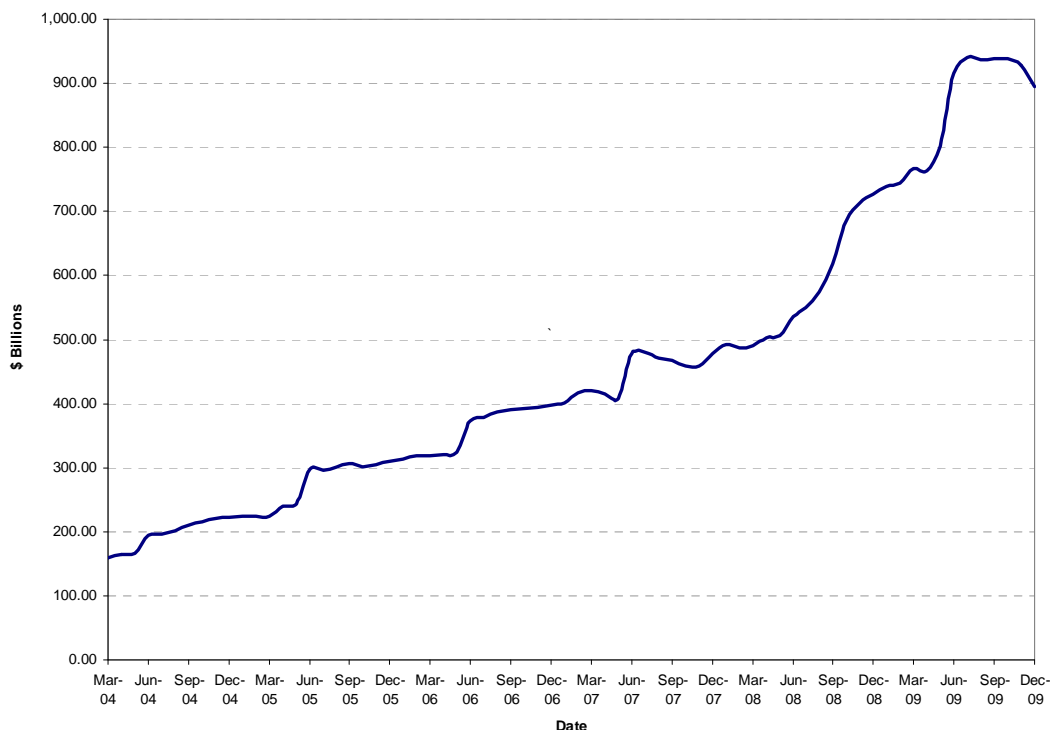
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Why Are the Chinese Selling Treasuries? (Perhaps Not For the Reasons You Think)

With budget deficits and the U.S. national debt projected to grow to unprecedented levels for the foreseeable future, concern is growing as to how that debt will be funded.

A common notion is that the Chinese will be responsible for much of that funding, primarily as a reciprocal action for continued trade surpluses with the U.S., although that surplus is declining as the U.S. economy continues to languish. However, it has been evident for some time now that Chinese enthusiasm for continued funding of U.S. deficits may be waning, and fast. The tables below show total Chinese holdings of U.S. Treasuries declining. The message is clear – beginning in June 2009, the Chinese began reducing exposure to the U.S. Treasury market.

Total Chinese Holdings of U.S. Treasuries, 2004-2009



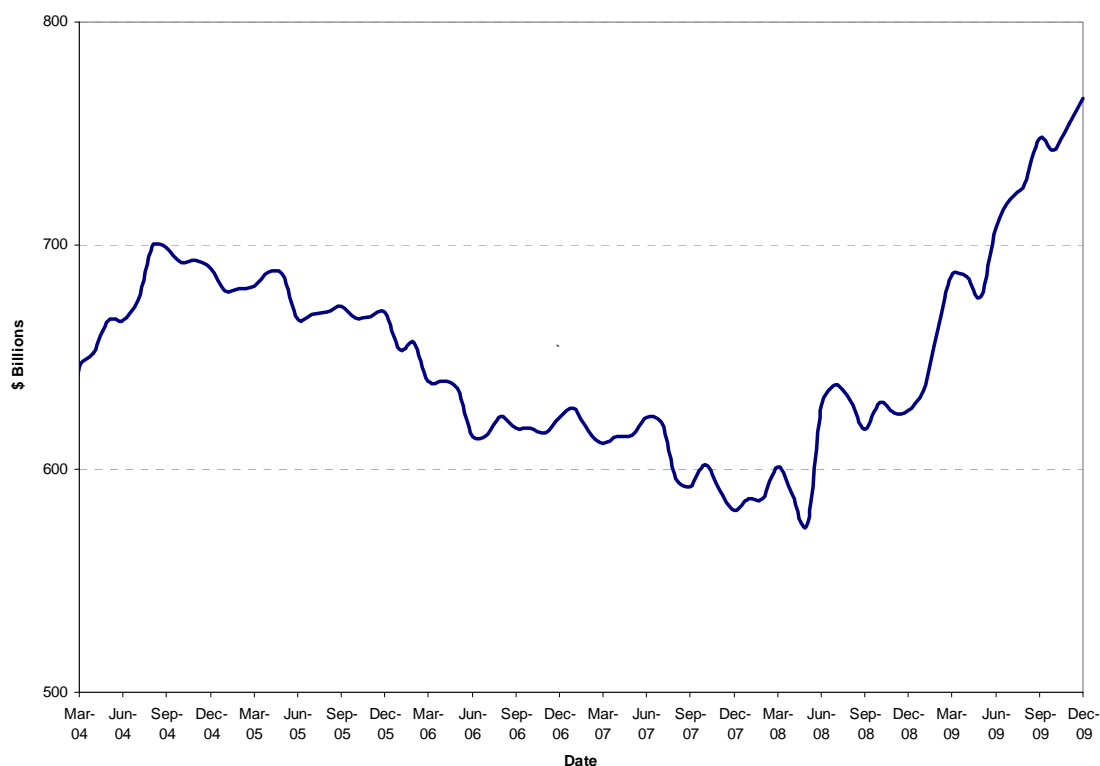
Source: Bloomberg

So far, however, the Treasury market appears to have found sufficient buyers as long-term yields have been range-bound for some time. This range, however, could reflect the stabilizing effect of the quantitative easing program by the government, which is effectively a buy back program by the Federal Reserve. This program is now projected to be completed by the end of Q1 2010, (and would have been unsustainable as it amounts to nothing more than debt monetization) exposing the U.S. Treasury markets to the whims of the free market. Treasuries have also benefitted from the growing uncertainty about the future of the Euro.

However, the fear now is that the ever-increasing size of the U.S. budget deficit will eventually overwhelm the pool of buyers, leading to an alarming rise in U.S. interest rates, stifling any U.S. recovery especially in the stricken housing market. Morgan Stanley estimates that the shortfall in buyers for U.S. Treasuries in 2010 alone could be as much as \$500 billion, and that's a conservative estimate. Things are projected to get worse beyond that.

As the Chinese have reduced holdings, the Japanese have significantly increased their positions in U.S. Treasuries to the point where it is now they who could be, once again, the largest holders of U.S. Treasuries. The data is imprecise, but whatever it is, the two countries jointly hold the largest concentration of U.S. government securities outside of the U.S. The sudden increase in Japanese interest makes sense, given the near-zero interest rate environment in Japan and a backdrop of little or no inflation. The real return on long U.S. Treasuries is attractive to the Japanese, especially if dollar/yen is stable.

Total Japanese Holdings of U.S. Treasuries, 2004-2009

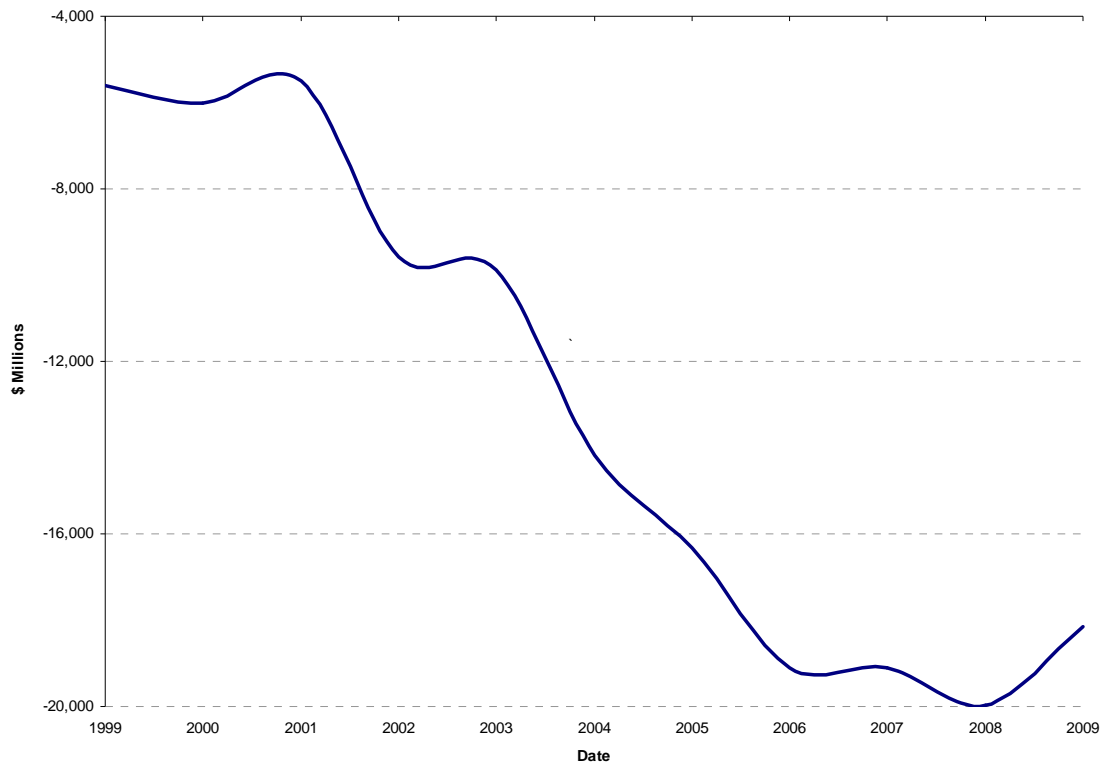


Source: Bloomberg

As nervous as these Chinese sales make the markets, it is not a one-way street. A significant percentage of China's \$2.7 trillion of reserves is held in U.S. securities, so any negative news affecting Treasury prices has an extremely detrimental effect on China's reserves. There is also some evidence that the reduction in holdings may also be a seasonal pattern caused by heavy U.S. Treasury bill purchases. This is still moot, but Chinese press reports encouraging a move away from U.S. investments is cause for concern. A recent statement by senior Chinese military officials encouraged the selling of U.S. assets as punishment for arms sales to Taiwan.

There may, however, be a more disconcerting reason for the decline. The supply of dollars needed to fund Chinese purchases may be declining along with the U.S./China trade deficit. As U.S. consumers continue to save (and not spend), the U.S. trade deficit has started to shrink, thereby reducing the amount of dollars available to make the required purchases.

U.S. Trade Deficit With China, 2000-2010



Source: Bloomberg

According to the deputy Governor of the Bank of China, given the falling supply of dollars, it is simply impossible for countries to 'double their holdings' – a requirement given the projected growth of U.S. debt. "The U.S. trade deficit is falling as residents' savings increase, so its trade turnover is falling, which means the U.S. is supplying fewer dollars to the rest of the world," he added. "The world does not have so much money to buy more U.S. Treasuries."

Whatever the recent pattern of the latest Chinese purchases, perhaps this is the more problematic issue facing the funding of U.S. budget deficit in the long-term. If growth remains strong in China (and elsewhere in the emerging economies), the U.S. trade deficit will shrink if the U.S. economy stays sluggish. Surplus dollars around the globe may decline. If U.S. rates trend up due to a lack of buyers, this could push the U.S. dollar higher making U.S. goods more expensive, thus exacerbating the problem.

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