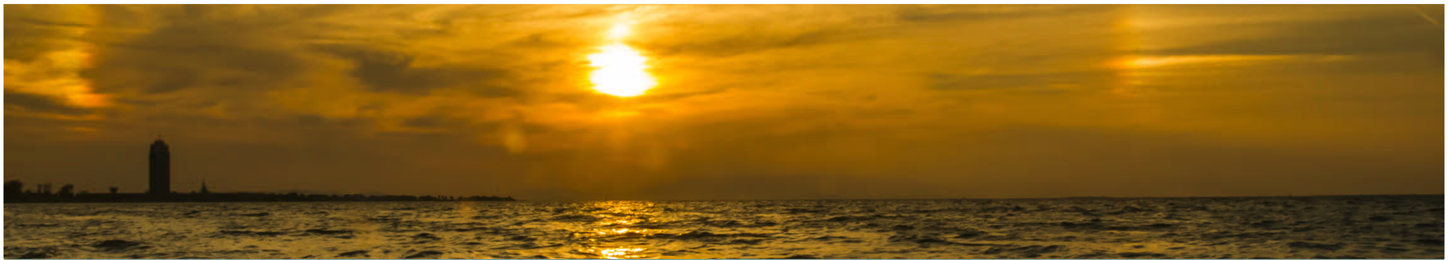

Should Investors Worry About China Selling U.S. Bonds?

by Matthew Pasts, CMT, CEO, BTS Asset Management, Inc.

At BTS we often say investors should increase the level of attention they pay to the price side of bonds, because we believe the risk of principal loss, especially in a low-interest rate environment, is higher than many people realize. It's important to focus on supply and demand factors as part of that focus on bond prices. China's sales of U.S. bonds has been in the news recently and warrants consideration, because in theory, heavy selling by the U.S.'s largest foreign creditor could flood the market with Treasuries and thereby depress prices.

As we saw during the "taper tantrum" of 2013, high volume of U.S. bond sales by foreign central banks can bring yields up in ways that have practical effects on the U.S. economy. An example is 2013's higher mortgage rates that threw the real estate recovery off track for a couple years. Just as importantly, high volume bond sales can affect Federal Reserve policy making. The "taper tantrum" selling led the Fed to extend its quantitative easing program of bond purchases and to delay any policy rate increases. The effect is now, two years later, the Fed's policy rates are still near zero, which means it lacks a traditional tool of economic stimulus should a slowdown set in.

In these economic and policy-related ways, low demand (or outright sales) of U.S. bonds can affect the general level of growth in the U.S. and globally, as well as corporate profits. So what should we make of China's current low demand for Treasuries?

The Chinese government's recent reduction of its Treasury holdings is its first since at least 2001, with a cut of about $200 billion worth of U.S. debt as of last fall, according to Bloomberg. But there are potential offsetting factors that probably mean this won't be a repeat of the "taper tantrum" effects on yields. For example, we think Chinese private entities are likely to increase their purchases of U.S. bonds even as their government lessens its holdings. That's because the Chinese government's focus on economic stimulation—in part with proceeds from the bond sales and relating to the devaluation of the renminbi—is likely to lead to an increase in the Chinese money supply, leaving investors seeking a return on capital.

Furthermore, apart from China, private entities here in the U.S. have also been aggressive purchasers of U.S. debt. For example, U.S. mutual funds have substantially increased their Treasury purchases, according to Bloomberg. For now, anyway, there's no big overhang of supply in the market.

Commercial banks are another group that have loaded up on Treasuries, helping to further offset selling by the Chinese central bank. One reason banks are buying is that their corporate customers are seeking return on cash holdings—and, though it is hard to believe, the 2% yield on our 10-year bonds is attractive in comparison to yields in Europe and Japan given quantitative easing strategies there. Moreover, Gundlach points out that most high yield debt is slated to roll over toward the end of this decade. Investors could be shocked, he says, by markdowns in the price of their high yield bonds (including in mutual funds and ETFs) if a glut of corporate borrowers struggle to roll over obligations at higher interest rates.

Furthermore, the strong dollar makes U.S. bonds appealing to foreign corporations who can leverage currency valuation differences into trade gains.

So for the moment, the supply and demand equation does not seem worrisome.

But what if the dollar trend slows down or inflation takes hold? Consider that Headline CPI is low—owing largely to low gas prices—but Core CPI is notably higher, at 1.9%. We think we could see Headline CPI of 1.5% by June 2016. Higher inflation could finally lead the Fed to set higher policy rates.

If and when the Fed does raise rates, demand by private purchasers for U.S. bonds could dry up for a period of time. Still, we think that reduction in demand would likely be a relatively short-term event, with U.S.-based buying likely to continue on a strengthening dollar (a likely effect of rate hikes) and a general perception of low inflation for the future.

The initial policy rate hike is likely to strengthen the dollar, which could either stem sales of U.S. bonds or even attract new assets. However, we think the initial policy rate increases will affect bond yields for a relatively short period of time. Ultimately, it's longer-term low inflation that has the potential to stabilize the bond market, together with asset flows to bonds coming from the stock market, where P/E ratios still remain historically high and many valuations rely on a low cost of capital, given near-zero interest rates.

On the other hand, if low inflation takes hold in a slow-growth context (a renewed economic soft patch) with concerns about employment, then we could see a weakening dollar. That could lower inflation expectations and stabilize bonds prices—but, again, on the other hand, a falling dollar may reduce demand from foreign banks and commercial banks.

The bottom line is that for now, supply and demand trends in the market for U.S. bonds seem to offset each other. We'll be watching closely as the various large-scale buyers and sellers of bonds react to changing economic and policy conditions.

Eventually, rates will rise further and we will enter a new era for the bond market. Although market observers can speculate about the dollar, inflation, and supply and demand factors, it's impossible to know with certainty how key entities will react.