Markets Eye China's US Treasury Investment Strategy (2)

Significance of Increased Investment in Yen Assets

Japan Equity Strategy

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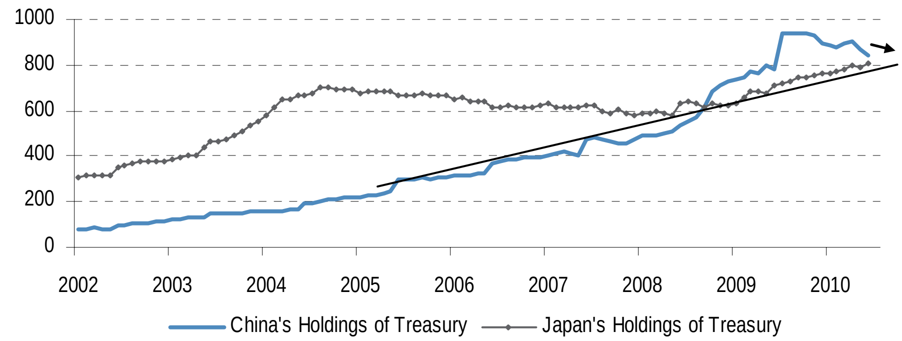
- On February 22 we published our first note on China's investment strategy in US Treasuries, prompted by the US Treasury Department's February 16 release of its Treasury International Capital (TIC) report for December 2009. This showed that China's holdings of US government bonds had declined by a sharp $34.2 billion. Since the latter half of 2009, China's holdings of US treasuries have remained on a downtrend (Figure 1).

Figure 1: US Treasury Holdings of Japan and China

$ billion

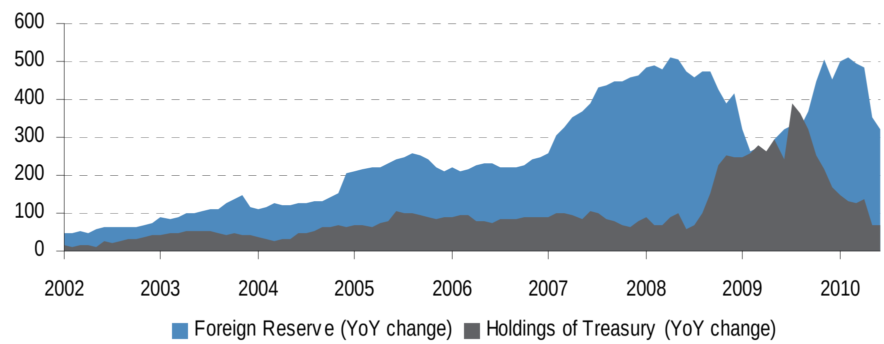


Source: Bloomberg, J.P. Morgan.

- As we analyzed from the February 16 report, the decline of China's Treasury holdings from 2H 2009 was, we thought, a correction following the surge of its holdings from the latter half of 2008. Figure 2 plots the YoY change in China's forex reserves and the YoY change of its US Treasury holdings. As markets fell into turmoil following the Lehman shock, China arguably increased its allocation to Treasuries, a relatively safe asset. Then, as the financial crisis abated and the real economy began to recover, China sought to return the level of its Treasury holdings to the original trend (Figure 1). We concluded, therefore, that there was probably "no reason to overreact to China's current short-term moves".

Figure 2: YoY Change in China's Foreign Reserves and Holdings of US Treasuries

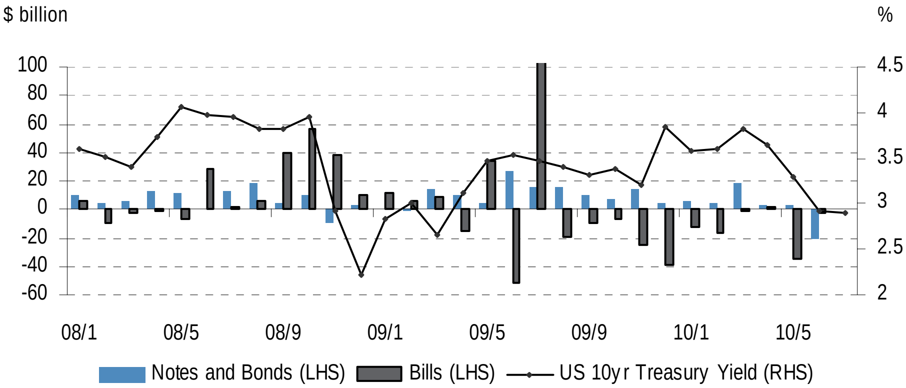
$ billion



Source: Bloomberg, J.P. Morgan.

The US Treasury Department released the TIC data for June on August 16. Following a $32.5 billion reduction in May, China's Treasury holdings again dropped in June by $24.0 billion. What is of interest here is the change in China's buying and selling transactions in US Treasuries. Figure 3 plots China's net purchases of Treasuries. Since the latter half of 2009 China has pursued an investment strategy of selling short-term bonds and buying long-term bonds. In June, however, China was a net seller of both short-term and long-term bonds. Its net sales of long-term bonds, in particular, hit an all-time high of $21.2 billion. Its second largest net sale to date, incidentally, was $14.2 billion in August 2007. Excluding that, instances of monthly net sales were nearly always in amounts less than $5.0 billion.

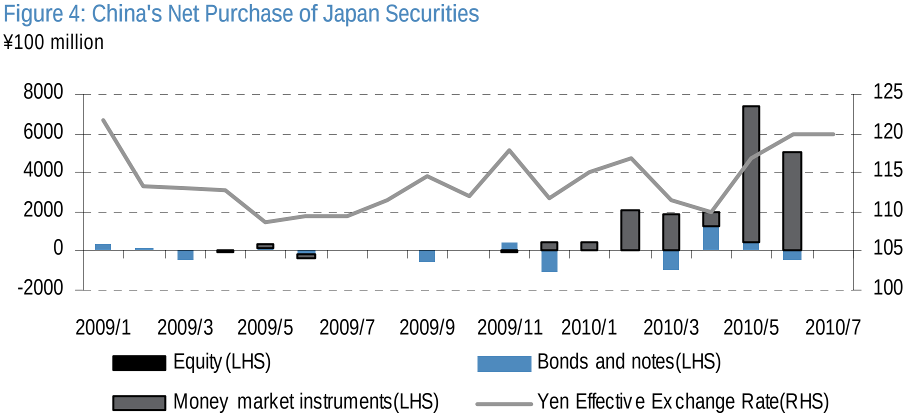
Figure 3: China's Net Purchase of US Treasury and US Long-term Yield



Source: Bloomberg, J.P. Morgan.

Another change is China's increased investment in Japanese government bonds (JGBs). According to MoF's balance of payments data, China's net purchases of Japan securities from January-June this year amounted to ¥1.73 trillion, nearly seven times the 2005 full-year record (since data have become available). Nearly the entirety of the increased purchases came in the form of short-term bonds (Figure 4).

Figure 4: China's Net Purchase of Japan Securities



Source: BoJ, Bloomberg, J.P. Morgan.

How should we view these recent turnover trends? China's State Administration of Foreign Exchange (SAFE), positioned beneath the People's Bank of China (PBoC), is charged with the management of China's $2.4 trillion in forex reserves. However, the composition of those assets and records of their transactions are state secrets that are not made public. According to materials available on SAFE's website, the management of forex reserves is conducted under the principles of safety, liquidity, and profitability. Allocation aims to diversify currencies and asset classes in order to achieve a balanced portfolio. The basis for allocations is derived with reference to the structure of China's economy, such as trade, foreign direct investment (FDI), and settlements, as well as the scale of the markets in target countries. Once the specific composition of the currencies to be invested in is determined, allocation to assets denominated in those currencies is undertaken from a long-term and strategic standpoint.

Based on the above, we can perhaps make an educated guess, to some degree, about China's thinking on forex and interest rate markets. First of all, China's recent sales of dollar assets and buying of yen assets arguably reflect a view that the dollar will depreciate and the yen will appreciate. Also, considering the level of asset allocations, China's net sale of US Treasuries in June was its first in 16 months. Perhaps the Chinese authorities are taking precautions against a rise in US interest rates. Meanwhile, the fact that China's buying of net purchases of yen assets was almost entirely in short-term JGBs may suggest that the concerns of the Chinese authorities over the long-term problems of the Japanese economy have not been dispelled, and that they increased their exposure looking for a short-term appreciation of the yen.

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