Japan, U.S. Treasuries And Emerging Markets

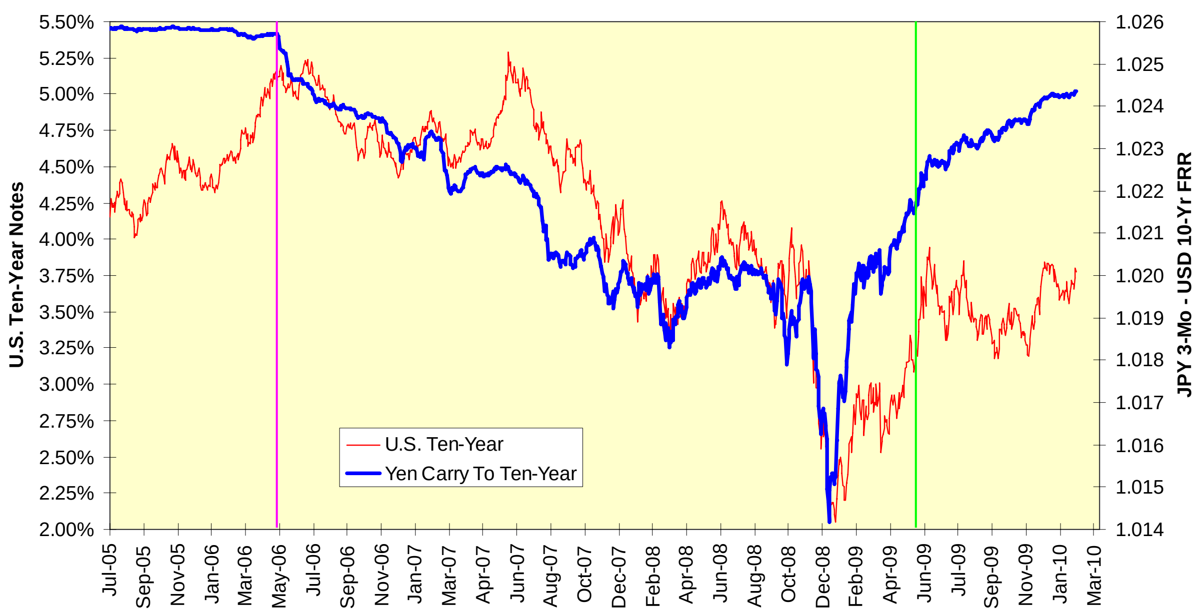
Last week's Treasury International Capital Statistics report was considered noteworthy in some quarters because it showed Japan had passed China as the leading holder of U.S. Treasuries. Before you rush off to mail a booby prize of sorts to Tokyo, take the headline data with a grain of salt or a jolt of wasabi. If China is the leading exporter to the U.S., it becomes the leading recipient of dollars in payment, and these dollars are by definition claims on U.S. assets.

Those dollars can return to the U.S. directly in the form of portfolio investment, or as the reserve currency they can be used by China to pay their suppliers, such as Japan. It matters not whether the direct buyer of U.S. Treasuries is Japan, China, a hedge fund domiciled in London or the Caribbean; it is an accounting identity the U.S.' current account deficit and capital account surplus are equal. Put aside your fears the deficit will not get funded; China will invest here unless it wants to start shutting export industries down and facing the consequences domestically.

The Yen Carry Trade

For those still worried about China financing our deficits, consider the relationship between ten-year Treasuries and the carry from three-month yen LIBOR to those Treasuries. This is measured as the ratio of the forward rate from three-month rate to ten-year UST, divided by the ten-year UST yield itself; the more the ratio (FRR) exceeds 1.00, the greater the carry. Two dates are marked on the charts below, the May 12, 2006 date when the Bank of Japan tried to tighten credit and the May 22, 2009 date referred to in **last week's discussion** of China and U.S. fixed-income markets when China's money market yield curve started to flatten.

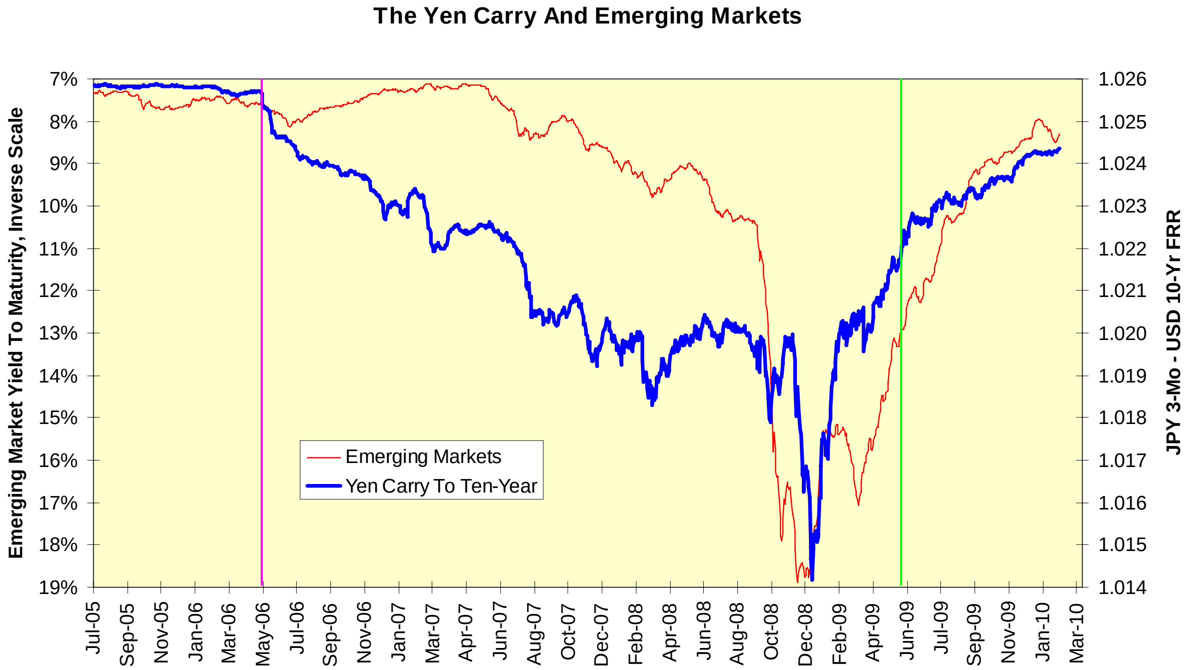
The Yen Carry And U.S. Treasuries



If you did not look at that chart and say, "Hmm. It looks like a tight relationship from May 2006 to May 2009 broke thereafter," then please say it now. The r^2 broke from 0.66 to 0.023. If the 2006-2009 relationship held, ten-year notes would have yielded 5.09% on Friday instead of 3.77%. Something is filling that funding gap, and that something is the posited flow from China.

Emerging Market Link

The yen carry trade is still directly important to emerging market yields. As the FRR has re-steepened, emerging market yields, plotted inversely, have plunged. Emerging market bonds are gorging still on cheap yen. This is different from the U.S., where it takes a combination of the yen carry trade, posited Chinese policy and still-expansive monetary policies in the U.S. to account for the continued low level of American long-term interest rates.



The worries whether China will continue to finance the U.S. deficits should be assuaged by repeating, “We have been running deficits once thought to be unimaginable and have lower long-term interest rates than we thought we would have.” So long as China wants to export to the U.S., it will send the dollars back to us, perhaps via Japan or another source, but they will get here.

Do not worry about the purported source of the funds, either. All China would need to do is an interest rate swap where it would receive the fixed-rate; the counterparty (perhaps Goldman-you-know-who) would then hedge its floating-rate receiving by buying U.S. Treasury securities. That would look like an American buyer as far as the Treasury statistics go.