China Not Dumping Two-Year Treasuries

One of the bad parts about being a debtor is you have to worry every now and then your creditors are going to pull the plug. Not to express concern would be bad form. As repeated worries about who will finance the U.S. go back to the Bretton Woods collapse of the late 1960s and early 1970s and continued through frets about OPEC/Japan/Taiwan and China waking up one day and dumping their Treasury holdings, no one can accuse the U.S. of being in bad form.

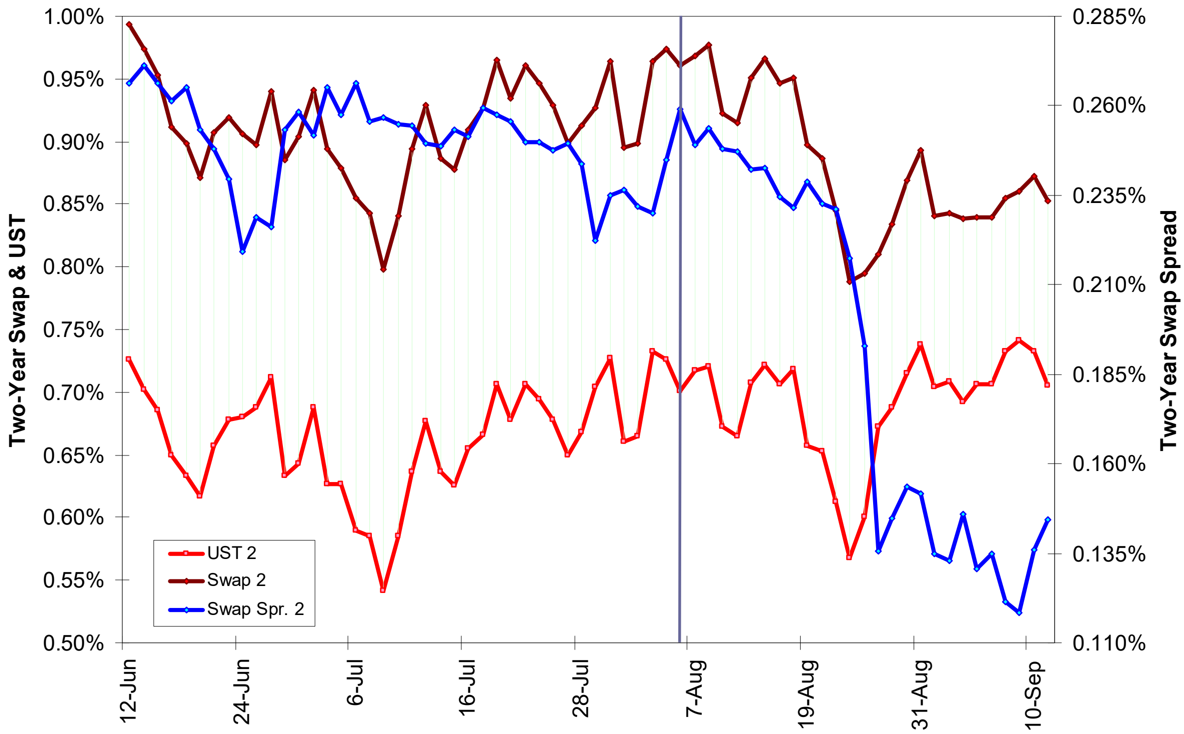
Never mind their holdings of Treasuries represent the flip side of their current account surpluses with the U.S. and that any dumping of Treasuries would have to be matched by lower exports to the U.S. and losses on their existing bond portfolios, the worries remain and will remain.

Two-Year Swap Spreads

The latest exercise in knuckle-cracking involves the sharp narrowing of the spread between two-year swaps and two-year Treasuries during the last week of August. The logic was simple: China had devalued the yuan (CNY), the world unceremoniously emitted a brick in response thereto and now China decided to defend the CNY by selling Treasuries and buying yuan.

If the sharp contraction of two-year swap spreads was the result of China selling two-year UST to support the CNY, it is hidden in the data. The contraction in two-year swap spreads began on August 6, 2015 (vertical line). This was five days before the devaluation of the CNY and more than two weeks prior to the large decline in swap spreads seen between Friday, August 21, 2015 and Monday, August 24, 2015, the so-called "Black Monday" global equity selloff.

Contraction Of Two-Year Swap Spread Began Prior To CNY Devaluation



If we repeat the exercise for five- and ten-year swap spreads, we see five-year spreads began to narrow on August 12, 2015 and have continued to narrow rapidly. Ten-year swap spreads began to narrow on August 9, 2015 and declined gradually until a stronger decline began on September 8, 2015.

These dates would force us to accept Chinese moves prior to the August 11, 2015 devaluation involving the sale of UST and purchase of CNY were singularly ineffective at preventing the devaluation and had no upward pressure on

U.S. interest rates while Chinese moves afterward stabilized the CNY and forced a narrowing of swap spreads via higher UST rates.

We know China is liquidating reserves to support the CNY, a move of dubious wisdom as it necessitates lower banking system liquidity within China and the acceptance of an arguably overvalued CNY. However, the direct connection between this policy, the movement of U.S. swap spreads at these three tenors and the path of UST rates cannot be dissected from the cross-current affecting UST, including the still-unsettled outlook for the Federal Reserve and high levels of volatility in equity markets.

Let's cross wholesale Chinese dumping of short-term Treasuries off of our list of worries. What we should be worried about is the Chinese Communist Party's belief it can command and control markets to achieve conflicting goals and at times and places of its choosing. Fortunately, the U.S. would never allow such arrogance to be concentrated in an unelected body with such a long track record of failure to achieve stated goals; that's why we have the Federal Reserve.