

Bond Market Perspectives

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Highlights

There is more than meets the eye to foreigners' reduction of Treasury bonds in December 2011, as multiple factors can influence foreign buying habits.

More recent data suggests that foreign buying has resumed in 2012, but addressing the long-term United States fiscal deficit in 2013 will likely be required to maintain longer-term foreign buying interest.

More Than Meets The Eye

Foreigners sold \$17 billion worth of Treasury notes and bonds in December 2011. It was only the third net monthly sale of Treasuries by foreigners over the past three years. For all of 2012, net foreign purchases of U.S. Treasuries totaled \$376 billion, a slowdown from the \$703 billion of net purchases in 2010, according to Treasury International Capital System (TICS) data.

Since foreigners own nearly half of outstanding marketable U.S. Treasury debt, foreign buying habits are closely watched, and any reduction can be cause for concern. Like any economic data release, there is more to the latest round of foreign ownership statistics than meets the eye. Multiple factors can influence foreign buying habits of U.S. Treasuries, including safe-haven buying, changes in trade flows, changes in a country's foreign exchange reserves, and international currency fluctuations. More recent data suggests foreign buying is on the upswing again.

A Closer Look at Underlying Trends

A closer look at underlying trends helps explain the motivation behind foreign buying habits in December and all of 2011.

Foreign selling of Treasuries in December 2011 followed four months of robust purchases. From August through November, foreign Treasury purchases averaged \$54 billion per month. Heightened fears over European debt problems in August and September clearly benefited Treasuries over that period. At the end of November and through mid-December, more robust central bank action, such as the Federal Reserve's coordinated U.S. dollar swap credit lines and the European Central Bank's (ECB's) 3-year lending facility, alleviated European bank funding risks and likely motivated modest selling given four months of solid buying.

The strength of the U.S. dollar likely influenced Treasury sales in December. From the end of August 2011 through December 15, 2011, the U.S. dollar appreciated by nearly 7% (as measured by the U.S. Trade Weighted Broad Dollar Index). In addition to the positive performance of owning U.S. Treasuries, foreign holders received an extra boost from a rising U.S. dollar. With year-end approaching, foreign investors likely gave pause to adding to an already increasing position.



1 China's Buying Habits Have Been Closely Correlated With Trade



Source: China Customs, U.S. Treasury, Haver Analytics 02/17/12

A Closer Look at China

Foreign selling of Treasuries was largely attributable to China's \$32 billion reduction of U.S. Treasury holdings. Moreover, China has been a net seller of Treasuries for three consecutive months, according to TICS data. Since China is the largest foreign holder of U.S. debt, this too could be cause for alarm. Among foreign holders, China's buying habits are scrutinized most closely.

Mitigating China's sale of Treasuries, however, were offsetting purchases of other U.S. government securities. China was the largest buyer of U.S. agency and agency mortgage-backed securities in December, purchasing \$9.5 billion. Part of China's decision to reduce Treasuries appears driven by simple diversification.

With China, or any country for that matter, country-specific factors can influence buying habits rather than a sudden change in heart towards Treasuries. Over the years, China's buying habits have been closely correlated with trade [Chart 1]. Expanding global trade has led to rising currency reserves that need to be reinvested, and Treasuries have been a prime beneficiary. China's slowing pace of Treasury purchases follows a few years of heavy buying that outpaced export growth.

2 A Reduction in China's Currency Reserves Help Explain December Sales

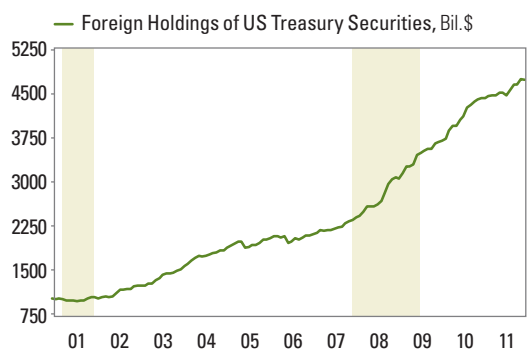


Source: China National Bureau of Statistics, Bloomberg, LPL Financial 12/31/11

China's Treasury holdings accelerated in late 2008 on safe-haven buying, and then in 2009, China resumed aggressive purchases to help slow the appreciation of its currency. Since emerging market countries were much less affected by the Great Recession, Treasury purchases were used to help slow or halt the appreciation of their currencies to help avert a slowdown in trade exports, which in turn could adversely impact export-driven emerging market economies.

Related to trade, China's foreign exchange reserves declined towards the end of 2011 and also help explain sales of Treasuries in December [Chart 2].

3 A Slower Pace of Treasury Buying in 2011 Was to Be Expected, Given the Accelerated Pace of Recent Years and Last Year's Global Economic Slowdown



Source: U.S. Treasury, Haver Analytics 02/17/12

(Shaded Areas Indicate Recession)

On a broader level, China's slowing pace of purchases helps explain why foreigners overall purchased fewer Treasuries in 2011 versus 2010. The following factors influenced a slower pace of Treasury buying in 2011.

- The global economic slowdown of 2011 resulted in less trade, which in turn reduced growth of foreign exchange reserves that could be reinvested into Treasury bonds.
- The Federal Reserve (Fed) increased Treasury holdings by \$650 billion in 2011, due to large-scale Treasury purchases as part of round two of quantitative easing (QE2), versus a much smaller \$224 billion in 2010. Increased Fed buying may have crowded out foreign purchasers in 2011.
- A slower pace of buying was to be expected after an accelerated pace of buying from early 2008 through late 2010 [Chart 3]. Overall, Treasury purchases increased for the eleventh consecutive year.

More recent data that tabulates foreign holdings of U.S. Treasuries held in custody at the New York Federal Reserve shows foreign purchases on the upswing once again [Chart 4]. Fed data on custody holdings are a good proxy for recent foreign buying habits and over longer periods of time closely matches TICS data. TICS data is released with a significant lag (six weeks)

4 More Recent Data Shows a Resumption of Foreign Buying



Source: Federal Reserve, LPL Financial 02/15/12

and is notorious for being subject to large revisions. The jump in Chinese holdings in mid-2010 (as shown in [Chart 1](#)) was due to a sizable upward revision. We believe China's holdings may be understated once again, leading to questions about the true extent of December's Treasury sales.

We do not believe foreigners' attitudes towards Treasuries have changed, and there is more than meets the eye to last week's data on foreign Treasury purchases. A number of factors influenced buying habits not only for December but also for all of 2011. We expect foreign purchases of Treasuries to resume as indicated by more recent Fed data and especially so given lingering concerns over European government debt.

Sizable foreign ownership of Treasuries is to be taken seriously and another reason why addressing the long-term deficit soon after the presidential election will be necessary. Foreign holders will want to see notable progress on reducing the deficit soon after the presidential election, or the risk of waning foreign demand could become a reality in 2013 and beyond. ■

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Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise and bonds are subject to availability and change in price.

Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

International and emerging markets investing involves special risks, such as currency fluctuation and political instability, and may not be suitable for all investors.

Mortgage-Backed Security (MBS) is a type of asset-backed security that is secured by a mortgage or collection of mortgages. These securities must also be grouped in one of the top two ratings as determined by an accredited credit rating agency, and usually pay periodic payments that are similar to coupon payments. Furthermore, the mortgage must have originated from a regulated and authorized financial institution.

Quantitative Easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

Treasuries: A marketable, fixed-interest U.S. government debt security. Treasury bonds make interest payments semi-annually and the income that holders receive is only taxed at the federal level.

The Trade Weighted US dollar Index is a measure of the value of the US dollar relative to other world currencies. Its numerical value is determined as a weighted average of the price of various currencies relative to the dollar, however it differs in which currencies are used and how their relative values are weighted.

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