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U.S. Treasuries Face Stronger Headwinds

The current U.S. federal budget deficit is roughly more than 5 percent of national income. A lion share of this deficit is financed by the U.S. Treasury Department's additional issuance of U.S. Treasuries that are purchased by the Fed. U.S. Treasuries are often regarded as the "safest" collateral used to backstop the financial systems, given the USD's status as a reserve currency.

Since 2013, there has been a gradual fall in overseas purchases of U.S. Treasuries. The U.S. Treasury market appear to be facing stronger headwinds due to factors ranging from the current Russia and Ukraine tension leading to Russia's attack on petro-dollar, the mysterious drastic dumping of U.S. Treasuries in the recent months, to the latest minutes from the Federal Open Market Committee (FOMC), which suggested that the near-zero rate policy is here to stay until the U.S. economy recovers with an inflation rate of 2%. In addition, the increase in the purchasing of Yuan-based assets by global central banks is hardly a source of comfort to U.S. policymakers.

"Latest minutes from FOMC suggests that the near-zero rate policy is here to stay."

With the benchmark U.S. 10-year Treasuries yield at its historical low, it is not unfair to ask how quickly yield will eventually have to rise once the quantitative easing program (QE3) ends, in order to absorb the enormous amount of new U.S. debt being issued.

In a joint press conference held by the U.S. president and his Japanese counterpart in Tokyo on April 24, President Obama explicitly stated that the US-Japan Security Treaty will cover territories administered by Japan, including the hotly disputed Senkaku/Diaoyu Islands. Such comments are likely to become a point of tension with China. Although China is motivated to protect the value of its massive stockpile of US Treasuries, we will not exclude the possibility that it may imitate recent Russian actions to put pressure on US Treasuries as a reminder to the U.S of its addiction to Chinese financial support.

This scenario – **U.S. Treasuries Face Stronger Headwinds,** is available to users on the HedgeSPA Platform.

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Chinese Black Swan

In our February newsletter, we mentioned that the increasing trend of China's non-performing loans is expected to persist. The latest data from Huarong, the nation's largest manager of bad debts, has reaffirmed this trend. The worst is far from over as China's non-performing loan ratio continues to rise for the ninth straight quarter since December 2008. Just in the first two months of this year, new non-performing loans have amounted to more than $9.6 billion USD.

"China's economy is facing downward pressure but government would not provide short-term stimulus measures."

Chinese Premier Li Keqiang, who is also China's top economic official, said last week that China's economy is facing "downward pressure", but the government would not provide short-term stimulus measures.

China's slowing economy made it more complicated for borrowers to repay debts, and the soaring value of soured loans posed a risk to China's financial system. That said, it also appears that the probability of a financial crisis in China seems remote, so no one is willing to pay up to hedge their positions. Investors appear to have faith that the Chinese government, with roughly $4 trillion USD in foreign exchange reserves, is in full control of the situation. Although the HedgeSPA team believes that the probability for a Chinese hard landing is still remote, there may be rippling implications if the market perceives that to be possible. That could be our next Black Swan.

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"Japan posts its largest ever trade deficit of USD 134 billion last year."

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Japan and Abenomics

Japanese Prime Minister Shinzo Abe had a vision in which a weakened Yen would be a sure-fire strategy of increasing exports and reversing Japan's existing trend of widening trade deficit. Now, he might want to redo his calculations. Based on recent government data, Japan posts its largest ever trade deficit of USD 134 billion in its last fiscal year. According to the *Wall Street Journal*, the debate among economists isn't whether there will be additional loosening in Japan, but when.

It appears that the costs from promoting overseas sales of Japanese products overweight the benefits from a weaker Yen. The value of Japanese exports rose sluggishly at a rate of 10.8% due to weaker Yen, with a mere overall volume increase of 0.6% over the last fiscal year.

On the other hand, the value of imports rose at a much quicker pace of 17.3%, with a 2.4% increase in trade volume. The weakened Yen also failed to reverse the trend of outflow of Japanese manufacturing jobs to lower-cost countries.

According to Credit Suisse, the situation is far from optimistic this year. Export volume actually decreased slightly by 0.2% in the first quarter on a seasonally adjusted basis, while imports increased by 4.5% in volume. Should this situation persist with a weakening Yen, Shinzo Abe may need to rethink Abenomics.

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The IMF Impasse

The G20 summit held in Australia this year has not created a great deal of tangible results. The G20 nations have made an agreement in Sydney early this year to have "real and effective plans to lift the global economy by a further 2 percent" within the next 5 years.

However, according to Australian Treasurer Joe Hockey, the slow progress up till now has only allowed them to achieve one tenth of the target for this year, and the progress so far is unacceptable.

On the other hand, the delays in implementing changes to reform IMF have also been a great concern. The plan was approved during the 2010 summit in Seoul, which aimed to strengthen the role of countries from emerging markets like China and Brazil. G20 finance ministers said they were "deeply disappointed" with the U.S. delay on granting legislative approval, and many countries are unlikely to agree once again to wait a little longer for their American partners to decide on granting approval.

G20 ministers were deeply disappointed with the U.S. delay

According to the *Wall Street Journal*, in a statement to the IMF's steering committee urging the IMF to sidestep U.S. Congress, Brazilian Finance Minister Guido Mantega stated that, "The IMF cannot remain paralyzed and postpone its commitments to reform. Alternatives to move forward with the reforms must be found whilst the major shareholder does not solve its political problems."

Taro Aso, the Finance Minister of Japan, also suggested that IMF should seek an alternative, if Washington does not deliver by the end of this year.

U.S. President Obama's Democratic Party have tried to push through the reforms last month, but failed to do so due to objections from the Republicans, arguing that the reform would increase the contribution of U.S. while weakening its role.

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