RUNNING FOR COVER:
FOREIGN OFFICIAL HOLDINGS OF US TREASURY SECURITIES
 October 13, 2016

"I know what gold does to men's souls," says a grizzled prospector in the movie, "The Treasure of the Sierra Madre" (John Huston, director)

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OVERVIEW AND CONCLUSION

Foreigners hold a massive quantity and substantial share of United States Treasury securities. Such foreign ownership of and trading activity in UST therefore is an important variable for US government interest rate levels and trends, which in turn intertwine with yield elevations and movements in other American debt playgrounds. And of course to some extent, and in various (and sometimes changing) fashions and degrees, given the importance of America within the global economy, UST yields interrelate with and influence yields overseas, as well as assorted currency, stock, and commodity marketplace levels and trends.

Federal Reserve Board (and other key central bank) policy, inflation trends (in America and other major nations), equity adventures (for the S+P 500 and other important advanced nation and emerging marketplace benchmarks), and the strength of the US dollar will influence decisions by current and potential overseas owners of UST. So will numerous other economic as well as political factors such as the America's November 8, 2016 election and its aftermath.

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Many marketplace visionaries focus primarily on the grand total of foreign holdings of United States Treasury securities, ascents and descents in that sum, and that amount's relative share of US debt outstanding. This indeed can provide observers with helpful information.

Yet in regard to UST ownership by overseas entities, the foreign official and private sectors do not necessarily behave the same way. Sometimes this distinction appears significant enough over time to monitor closely.

Thus concentrating on the grand total of foreign holdings and shifts in that statistic risk overlooking an important pattern which appeared in recent months within those holdings. What is that pattern? The net foreign official holdings have fallen not only as a percentage of overall foreign holdings, but also in absolute levels. This substantial official exodus is important.

Suppose not only that such noteworthy net UST liquidation by the foreign official sector persists, but also that the overseas private sector decides to reduce its net buying significantly, or to become a net seller. All else equal, that will help to push UST yields higher.

Selecting variables regarding as well as presenting explanations ("causes") for marketplace and other cultural phenomena reflect the subjective viewpoint and rhetoric of the given storyteller. And marketplace history does not necessarily entirely or even partly repeat itself. Net foreign official selling (or net buying) of US Treasury securities of course is not always or the only factor relevant to American stock marketplace trends. Marketplace participants nevertheless should note that sometimes over roughly the past two decades (since 1997), substantial net foreign official selling of UST can be associated with a decline in the S+P 500.

US federal budget deficits indeed have plummeted from their pinnacles reached due to the global economic disaster. But they have not disappeared. And they probably will increase in subsequent years. So looking forward (and all else equal), if substantial net foreign selling of UST by both the foreign official and private groups exists, that will make it increasingly difficult for the American government to finance looming budget deficits. Will this eventually encourage UST yield rises? Perhaps the US public will help to fill the deficit financing gap, but it may take higher rates (better real returns) than currently exist to inspire them.

A DELUGE OF DEBT

"'A Ti-tan iv Fi-nance,' said Mr. Dooley, 'is a man that's got more money thin he can carry without bein' disordherly. They'se no intoxicant in th' wurruld, Hinnissy, like money.'" (Finley Peter Dunne's "Mr. Dooley" commenting "On Wall Street"; spelling as in the original)

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There are various measures of US federal (national) indebtedness. Also, reports regarding breakdowns in debt ownership at times vary in their presentation. But regardless of the analytical perspective embraced, foreign ownership of UST is substantial in absolute and percentage of debt terms.

The "Monthly Statement of the Public Debt of the United States (9/30/16) states that the "total US public debt outstanding" is about $19.6 trillion. Of this, about $5.4tr was intragovernmental holdings, leaving "debt held by the public" of about $14.2tr, of which $13.6tr (95.8 percent) was marketable securities. This roughly $14.2 trillion public debt is the key debt guideline for many observers; for example, see the US Congressional Budget Office's "An Update to the Budget and Economic Outlook: 2016 to 2026" (8/23/16). The Federal Reserve System holds about $2.5 trillion in US Treasury securities. Subtracting $2.5tr from $13.6tr leaves about $11.1tr"held by private investors" (of which over 95.4pc is marketable). See the Fed's H.4.1; 10/6/16. See also the Treasury Bulletin's, "Ownership of Federal Securities", Tables OFS-1 and 2; September 2016.

Compare the size of the public debt (whether total or only the marketable portion) with US GDP in 2015 of about $18.0 trillion and 2Q16 (annualized) of about $18.5tr (Bureau of Economic Analysis, Table 3; 9/29/16).

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Foreigners hold a gigantic quantity and substantial share of United States Treasury securities. The Department of the Treasury annually provides the "foreign-owned" percentage of marketable long-term US Treasury debt held by the public (including the Federal Reserve System, but less Treasury bills) as of end-June ("Foreign Portfolio Holdings of U.S. Securities" as of June 30, 2015; Table 2; May 2016 release). At end-June 2015, foreigners held 48.2 percent of marketable US Treasury debt, down slightly from end-June 2014's 50.4pc (end June 2013 was 50.1pc). The comparable figure in 2010 was 53.0pc, with 2009's 56.7pc and 2008's 61.1pc. Arguably the dip in the percentage from 2008's height partly reflected the Fed's ravenous accumulation of US government securities during its quantitative easing programs. However, the gross holdings of "foreign-owned" UST securities increased over the end-June 2008 through end-June 2015 span, from about $2.2 trillion to almost $5.5tr.

At end-July 2016, according to the most recent US Treasury's "Major Foreign Holders of Treasury Securities" report, foreigners (foreign official sector plus foreign private holders) owned about $6.25 trillion in UST marketable (and non-marketable) Treasury bills, notes, and bonds (Treasury International Capital System/"TIC"; 9/16/16, next release 10/18/16). As the "Major Foreign Holders" includes both T-Bills and non-marketable debt securities, its scope is a bit broader than the "Foreign Portfolio Holdings" survey.

The Treasury Bulletin's "Ownership of Federal Securities" lists "Estimated Ownership of U.S. Treasury Securities" (Table OFS-2). The foreign and international group apparently matches up with the total for the Major Foreign Holders group. For March 2016, the $6.29 trillion in foreign holdings (of marketable and nonmarketable Treasury securities) was 54.8 percent of the "total privately held" $11.46tr. For June 2016, it also was 54.8pc ($6.29/$11.5tr).

The TIC statistics for major holders list dollar ownership by country, but they do not reveal the split between official and non-official levels within individual nations. As of end July 2016, the two largest holders, Mainland China and Japan, respectively possessed about $1.22tr and $1.15tr.

RUNNING FOR COVER

A character in the film "It's a Mad Mad Mad Mad World" reasons: "Now look, let's be sensible about this thing. There's money in this for all of us. Right? There's enough for you, there's enough for you, and for me, and for you, and there's enough for…" [They all race to their cars]. (Stanley Kramer, director)

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End-July 2016's $6.25tr grand total for major foreign holders of US Treasury securities represents a modest increase, about $200bb, from the $6.05tr low attained over the past year (October 2015). However, July 2016 dips from levels just under the recent $6.30tr pinnacle (March and June 2016). At first glance, the roughly $40bb erosion in net foreign ownership may seem insignificant. It is small in comparison to the overall American federal debt outstanding, and as US budget deficits have not been massive in recent years. Besides, foreigners are not the only marketplace participants. American individual and institutions, even in a low yield environment, may elect to be net new buyers of Treasury debt securities.

But a sustained rise in US government debt yields may inspire both Americans and foreigners to be less inclined to add to their net holdings. They may even elect to become net sellers of UST securities. Thus the modest decline in the grand total foreign holdings in recent months is significant.

US government interest rates remain very low, and many European and Japanese government debt yields have been negative. Growing fears of an end to a low rate environment, even if that end occurs slowly, may inspire some players to flee from their ownership of US Treasuries and other "safe haven" debt securities.

Regarding the rising yield issue in relation to the end July 2016 fall in total major foreign holdings versus June 2016, the recent low yield in the US Treasury 10 year note occurred in July 2016, at 1.32 percent on 7/6/16. This edged only slightly below 7/25/12's 1.38pc bottom, which coincided with the European Central Bank President's "whatever it takes" speech (7/26/12) in defense of the Euro (and the Eurozone). In addition, see the bottoming pattern for yields during calendar 2016 in the five year, five year forward inflation expectation rate (Federal Reserve Bank of St. Louis). This indicator measures expected inflation (on average) over the five-year period that begins five years from today. Yield peaks in recent years include 2.84 percent on 1/5/14, 2.98pc on 1/14/13, and 3.02pc on 4/19/11. In 2016, initial lows occurred at 1.48pc on 1/21/16 and 1.42pc on 2/11/16. Subsequent troughs occurred at 1.41pc (on 6/17/16, 6/27/16, and 7/5/16). On 10/7/16, that forward inflation expectation rate was 1.76pc.

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Moreover, concentrating solely or even primarily on the grand total of foreign US Treasury holdings and its changes risks missing a very significant pattern which materialized in recent months within a subset of the grand total ownership. The net foreign official holdings have slumped not only as a percentage of total foreign holdings, but also in absolute levels.

In August 2015, according to the Major Foreign Holders statistics, foreign official holdings of US Treasury bills, notes, and bonds were about $4.18 trillion ($356bb in bills, $3.822tr in notes and bonds), about 68.5 percent of the $6.10tr grand total. However, foreign official holdings of these at end July 2016 fell almost $168bb to about $4.01 trillion, thus constituting 64.2pc of overall foreign ownership.

Treasury bills, at about $277 billion, equaled only 6.9pc of July 2016's roughly four trillion dollar foreign official inventory, with Treasury notes and bills about $3.73tr. In August 2015, foreign official holdings of bills stood at just under $356 billion, with UST notes and bonds at $3.82tr.

Analysis of these statistics underscores that the two subsets, official and private, within the overall foreign holdings do not necessarily act alike. From August 2015 to July 2016, since total holdings climbed about $146bb over that span, and since foreign official holdings fell nearly $168bb, the category of other foreigners (those who are not official holders) therefore rose over $313bb.

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A separate TIC report deals only with monthly foreign net purchases of US Treasury notes and bonds (does not include T-bills). These statistics go back to January 1978, with July 2016 the most current. According to the US Department of the Treasury, this transactions data does not include nonmarketable UST.

This report has three categories, which when combined equal the total net foreign purchases (or net sales) for the given month: foreign official institutions, other foreigners, and international and regional organizations. The international and regional organizations category is relatively minor. Negative numbers in the report indicate net sales by foreigners to US residents or a net outflow of capital from the US.

Over the past 22 months, from October 2014 through July 2016, foreign official institutions were net sellers of UST notes and bonds in 21 of them (November 2015's $892bb the exception). The grand total of official net sales was almost $474bb, or over $21.5 billion escaping per month.

View a shorter time span. The net selling of Treasury notes and bonds by foreign official institutions over the past eight months (December 2015 through July 2016) was nearly $269 billion, an average of $33.6 billion per month. Over that eight month span, international and regional organizations also were net sellers every month, averaging $1.8bb.

The grand total net foreign purchase monthly average over those eight months is a negative number; net selling averaged about $24.0bb per month. Thus net buying from "other foreigners" (the general public of non-official sources) in seven of those eight months reduced the impact of the $33.6bb monthly average foreign official selling.

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How substantial are these overseas official institution net sales in comparison to recent and anticipated US federal budget deficits? Very significant. America's fiscal 2015 deficit was $438bb (2.5 percent of GDP), with fiscal 2016 estimated at $590bb (3.2pc of GDP). See the Congressional Budget Office's "An Update to the Budget and Economic Outlook: 2016 to 2026" (Table 1.1; 8/23/16). The $21.5bb monthly average of net foreign official sales over the past 22 months is an annualized $258bb, or about 43.7 percent of the 2016 fiscal deficit. The more recent eight month average of $33.6bb, when annualized, equals $403 billion, or 68.3pc of 2016's deficit.

Though the budget deficit drops to $520bb in fiscal 2018 (2.6pc of GDP), it steadily grows thereafter. Although the annual percent deficit relative to GDP from 2015 through 2026 rests far under 2009's 9.8pc pinnacle, it is not minor.

It reaches $954 billion in 2022 (4.1pc of GDP; Figure 1-1 notes the average deficit from 1966 to 2015 was 2.8pc) and expands to $1.243 trillion in 2026 (4.6pc of GDP). The CBO predicts debt held by the public will rise from about $13.1 trillion in fiscal 2015 and about $14.1tr in 2016 (recall the $4.8 trillion in 2006 during the Goldilocks Era). Publicly held debt jumps to about $18.6tr in 2022 and over $23.1tr in 2026. It forecasts that debt held by the public as a percentage of GDP rises from 73.6pc in 2015 and 76.6pc in 2016 (it was 39.3pc in 2008, 52.3pc in 2009) to 80.5pc in 2022 and 85.5pc in 2026. It of course is a truism that "these forecasts are not written in stone" and "much can happen between now and then". However, given the important role foreigners have performed in financing budget deficits, marketplace watchers should underscore the recent pattern of net official selling in this context and watch to see if it continues.

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In Mark Twain and Charles Dudley Warner's novel, "The Gilded Age" (chapter 7), Colonel Sellers declares: "'Si Hawkins has been a good friend to me, and I believe I can say that whenever I've had a chance to put him into a good thing I've done it, and done it pretty cheerfully, too. I put him into that sugar speculationwhat a grand thing that was, if we hadn't held on too long!'"

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Marketplace sages label US Treasury securities "high-quality" instruments. Yet sustained rising US government interest rates (and higher Federal Funds levels) may make such government securities appear less attractive. As history often reveals, there can be a "flight from quality", not just "flights to quality". Rising inflation levels and tightening Federal Reserve policy often play key roles in inspiring substantial selling of, rising rates for, and bear marketplace trends in UST bills, notes, and bonds. The UST marketplace of course also influences trends in American corporate rates; yields for much foreign sovereign and corporate debt interrelate with those of the UST universe.

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Both in general and in the current context, observers of course should be cautious in generalizing regarding overall American yield (and other financial marketplace trends) from patterns of foreign activity and yields within the UST government universe alone. Obviously the US Treasury battlefield is not the only debt domain for foreign acquisition (or selling) of US debt securities. Think of US agency bonds as well as the corporate realm. Foreigners in those US debt sectors do not necessarily venture in the same net direction or in the same net quantities as in the UST territory.

Analysis of TIC report data for the eight months December 2015 through July 2016 reveal that total net foreign purchases of US long-term agency bonds by foreigners averaged $23.3 billion, with that for corporate bonds about $12.1bb. However, the foreign official net buying component of the US agency bonds averaged less than $3.5bb per month during that period. And despite the notable net overall buying in US corporate bonds, foreign official institutions were small net sellers over that period (they were net buyers in four months, net sellers in the other four), on balance liquidating about $270 million per month.

In addition, yield heights and trends in government securities weathervanes of other advanced nations such as Germany, Japan, and England (and of key emerging/developing nations) may influence those of the US Treasury securities playground. Could some holders of UST (whether official or private sector) have switched some of their US government debt ownership (thus being net UST sellers) into other debt obligations (whether in Europe or elsewhere).

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Venture back to the US Treasury's Major Foreign Holders report and scan individual countries. (Admittedly foreign holdings, whether official or private, could be anonymously included in jurisdictions outside the given home country.) Even though this survey does not distinguish between foreign official and unofficial holdings by nation, probably the holding of some nations involves a substantial official component. In any case, think of Mainland China, Saudi Arabia, and Russia. As of July 2016, Mainland China's $1.22 trillion had slipped from August 2015's $1.27tr. Saudi Arabia held about $97bb in July 2016 (down from about $124bb in January 2016). Russia held about $88bb in July 2016, slumping from January 2016's $97bb. Some of these nations may have somewhat tense political relations with the United States regarding various topics. Could they use the threat of UST sales as a negotiating tool?

What if American institutions and individuals decide to reduce their net buying or run for cover and become net sellers of UST? What if inflation starts to grow fairly rapidly in measures such as the consumer price index, personal consumption expenditures, and wages? The American private sector is not completely imprisoned in UST ownership. Will the Fed step in again and start buying UST in large quantities?

The outcome of America's 11/8/16 election of course will influence foreign (and US) attitudes toward ownership of US Treasury securities. The Committee for a Responsible Federal Budget (9/22/16) and others analyzes Clinton's and Trump's policies. The Committee offers a preliminary estimate: "Clinton's plans would increase the debt by $200 billion over a decade above current law levels…and Trump's plans would increase the debt by $5.3 trillion…As a result, debt would rise to above 86 percent of GDP under Clinton and 105 percent under Trump."

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The US broad real trade-weighted dollar attained its recent plateau in January 2016 at 101.2 (Federal Reserve, H.10; monthly average). Its recent low was April 2016's 96.3 (September 2016 was 97.9). Suppose the broad real trade-weighted US dollar should depreciate significantly beneath its 2016 low. All else equal, that could inspire reduced net buying (or boost net selling) by foreigners of US Treasury securities. In general, a feebler dollar accompanied by steadily rising US interest rates would be even more likely to induce such net foreign selling (or reduce net buying) of UST (whether by the overseas official sector, the private sphere, or both).

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“Always calculate the percentages on every play.” The Hall of Famer Ty Cobb (“My Life in Baseball”, chapter 11)

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Various intertwining variables related to inflation, economic growth, unemployment, central bank programs, budget deficits and levels, and so forth in America (and overseas) influence UST yield levels and trends. The Federal Reserve meets 11/1-2/16 and 12/13-14/16; it likely will delay rate rises until after the US 11/8/16 election. The Fed, even though it may raise the Fed Funds rate slowly, has not abandoned yield repression. Many of the Fed’s central bank friends such as the ECB and Bank of Japan retain ongoing easy money policies (including both yield repression and money printing).

Yet all else equal, significant net selling of UST by foreigners in general probably eventually will help to generate noteworthy US government yield increases. In any case, the net foreign official institutional selling of UST notes and bonds over almost the past two years (and the recent eight months) is unusual in the duration and size of the total liquidation (even allowing for changed times, including more issued and outstanding debt securities in recent years).

The ascent in UST rates may develop fairly slowly; fearful “flights to quality” could interrupt the climb. Nevertheless, given the extremely extended time span over which the Fed (and other central banks) has repressed interest rates, and especially if more inflation appears, the speed and eventual extent of UST yield increases may surprise many onlookers.

Even though the 10 year UST’s 5.32 percent peak on 6/13/07 during the Goldilocks Era appears like a distant ceiling to many marketplace players, 1/2/14’s top at 3.05pc did not occur in ancient times. If the 3.05pc roof is broken, watch around 3.75/4.00pc (2/9/11 high was 3.77pc, 4/5/10 top 4.01pc, 6/11/09 high 4.00pc; three times 7/6/16’s 1.32pc yield low equals 3.96pc).

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Noteworthy interest rate shifts (or dramatic stock, currency, and commodity moves) or financial crisis conditions do not necessarily link (whether closely in time or eventually) with net foreign selling (either in general or via official sources) of US debt securities. Yet in regard to the pattern of substantial net selling of UST notes and bonds by foreign official institutions over the past 22 months (and the most recent eight months), keep in mind that the July 2016 yield low in the UST 10 year occurred not long before the S+P 500’s recent high on 8/15/16 at 2194.

There was a modest burst of net foreign official selling of UST notes and bonds at the dawn of the worldwide economic crisis of 2007-09. Three of the four months from May 2007 to August 2007 saw net official selling, peaking with August 2007’s $29.7bb. In contrast, three of those four months saw net buying by “other foreigners”, which (as it has over the past 22 months), tended to mask (overcome, counteract) the net selling by foreign official institutions. The S+P 500 peaked on 10/11/07 at 1576.

And 10 of the 12 months from February 2013 through January 2014 saw net foreign official selling, at an average of $6.5bb per month. Does this earlier pattern, as it is not so distant in time from the past 22 month span running up through July 2016, further suggest (for whatever reason) reduced desire by foreign official institutions (governments and related entities) to own US government debt?

Some of this time span of February 2013 through January 2014 included the US “taper tantrum” episode, which began around late May through mid-June 2013, when the Federal Reserve Board suggested it would at some point gradually reduce its quantitative easing (debt securities buying; money printing) scheme. The S+P 500 tumbled 7.5pc from 1687 on 5/22/13 to 1560 on 6/24/13; the Fed guardian then presented some calming easy money wordplay, helping the S+P 500 to resume its rise. The UST 10 year yield rose from a low of 1.61 percent on 5/1/13 (not long before the S+P 500's interim top on 5/22/13), reaching 3.01pc on 9/6/13 and 3.05pc on 1/2/14.

In recent weeks, there have been rumors that the European Central Bank and the Bank of Japan at some point may elect to commence tapering their purchases. Many believe the Fed will raise rates in December 2016.

Also, during times of financial crisis, some foreign official institutions may liquidate some of their UST holdings to raise cash, most likely to meet needs on the given country's home front. Recall the Asian financial crisis which erupted around July 1997 and extended into 1998. Don't overlook the 1998 Russian economic crisis (including the mid-August/September default and ruble devaluation), as well as the September 1998 collapse of the hedge fund, Long-Term Capital Management.

October 1997 had a $12.5bb net selling burst of UST notes and bonds by foreign official institutions. The S+P 500 made a top on 10/7/97 at 983 (having made an earlier high 8/7/97 at 964), falling sharply (about 13.0 percent) to around 855 on 10/28/97. Other significant upticks in net selling of UST notes and bonds by foreign official institutions occurred in August ($16.9bb) and September 1998 ($10.3bb). The S+P 500 collapsed about 22.5pc from 7/20/98's 1191 to 10/8/98's 923. Was November 2008's sizable net sale of $26.2bb by foreign official institutions as the international economic disaster of 2007-09 worsened (and even though UST rates were in a downtrend; the UST 10 year low occurred 12/18/08 at 2.04pc) another instance of such crisis behavior?

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