Coffee Break

The *Coffee Break* is our new daily publication, offering topical insights as an intellectual ingot to start the day.

Decline in Chinese demand for USTs may not be as strong as it appears

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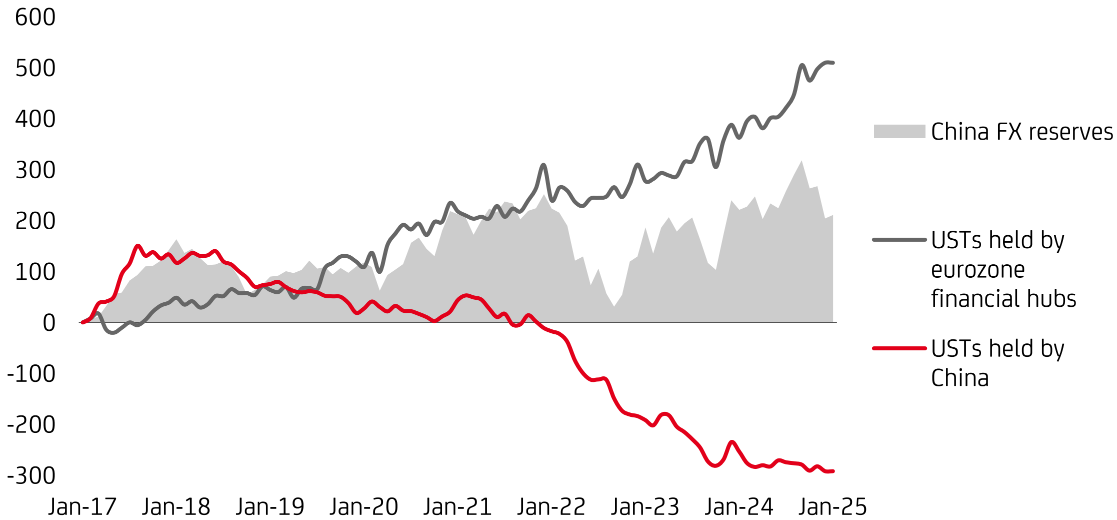
US Treasury data show that China's direct holdings of USTs have declined in recent years. However, these figures likely overestimate this reduction as Beijing may have shifted its USTs holdings to custodian accounts registered outside the US, particularly in Europe, to mitigate its direct exposure to a geopolitical rival.

IS CHINA REALLY HOLDING FEWER USTS?

CUMULATIVE CHANGES SINCE DECEMBER 2016 (USD BN)



Source: US Treasury, IMF, Bloomberg, The Investment Institute by UniCredit
Note: Eurozone financial hubs include Ireland, Luxembourg and Belgium.

THE CONTEXT

The robustness of foreign investor demand for USTs is a recurring topic of discussion in markets. A high deficit, coupled with the unpredictability of US President Donald Trump's policy messaging, has raised concerns that investors may turn away from this asset class.

This could lead to upward pressure on UST yields. One point frequently mentioned is that China has been reducing its UST holdings in the past few years. This is important because China is the second largest single investor in USTs (9% of total foreign holdings) but also because of the economic and political rivalry between the two countries. UST holdings make China vulnerable to possible financial sanctions from the US but are also a powerful financial threat in the hands of Beijing, and that is why they are often seen as a source of systemic geopolitical stability. It is in neither country's interest to weaponize them. Every month, the US Treasury publishes data on UST holdings by country. The January update, which is to be released tonight, will show whether China has continued to reduce its UST holdings.

THE DATA

Our chart shows the evolution of China's FX reserves as reported by the IMF, together with holdings of USTs held directly by China and by the main financial centres in the eurozone. Some cross-country dynamics are worth monitoring. In particular, China's holdings of USTs have declined by USD 300bn since the end of 2016, while there has been a USD 500bn increase in holdings of USTs by financial hubs in the eurozone.

OUR VIEW

Taken at face value, the data indicate that China has been cutting its holdings of USTs, but the picture might not be as simple as it looks. The reduction of its UST holdings has occurred during a period when the country's FX reserves have risen – they are USD 200bn higher than they were at the end of 2016. Data from recent years also do not point to a deterioration in demand from foreign investors, particularly from foreign officials (typically central banks and sovereign wealth funds). Moreover, a decline in UST holdings by China has been mirrored by an increase in UST holdings in Luxembourg, Ireland and Belgium (important providers of security depository services are headquartered in Brussels). This raises doubts as to whether demand for USTs from China is weakening as much as the national data suggest. While it does not serve as hard evidence, the increase in UST holdings in eurozone financial hubs suggests the possibility that China's is moving its holdings of USTs abroad rather than cutting them outright. This might be due to risk diversification, as Beijing could be trying to limit the concentration of wealth within the jurisdiction of a geopolitical rival. Political considerations might also be at play. Beijing is likely interested in showing that its overall exposure and vulnerabilities to the US are more limited than in the past, when the relationship between the two powers was stronger.

OTHER THINGS TO NOTE

Fed to keep rates at 4.25-4.50% – focus on new dot plot

Today, the Fed will very likely leave interest rates on hold on as it waits for greater clarity with regard to changes in government policy. The new "dot plot" will probably continue to signal two cuts this year, but Fed Chair Jerome Powell will likely downplay its use given heightened economic uncertainty. We are sticking with our view that quantitative tightening will run until June, although the risk of an earlier stop has risen following the January FOMC minutes. In terms of market reactions, we expect the FOMC meeting to put a lid on the recent EUR-USD rally. US bond markets may not respond strongly. They need to see recession fears vanishing and equity markets stabilising before they find a bottom. For further details, see our Central Banks Watch – Fed: waiting for greater clarity.

TODAY'S DATA RELEASES

Time (CET)	Country	Data	Period	UniCredit	Consensus	Previous
19:00	US	Federal Funds Target Rate (upper bound, %)		4.50	4.50	4.50

Source: Bloomberg, The Investment Institute by UniCredit

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