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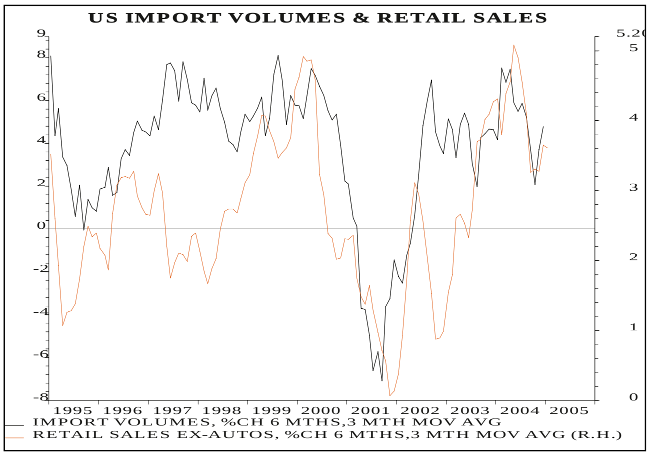
RESERVE DIVERSIFICATION COULD HIT US BONDS

Fears that reserve diversification would send the US$ down sharply at some point during the course of 2005 seemed a little far-fetched during the early weeks of the new year. As the US$ started to rally, the seriousness of the external financing crisis facing the US economy was once again played down. Frequently, it was argued the US trade deficit was not a problem, since it reflected the ability of the US economy to attract capital inflows. "You would clearly rather have capital lined up on your borders trying to get into your country than trying to get out" was a typical refrain being made in defence of the US$. (See "Destination U.S.A.," Arthur Laffer, WSJ, January 3rd 2005). But in reality, there was always a danger that central banks would cut and run, diversifying their US$ reserves, and in doing so trigger the next leg of the US$ bear market. Furthermore, once the 'quasi-fixed' exchange rate system of today did start to crumble, there was a risk that the US$ might fall even further than in the mid-1980s. That remains a key threat, as this week's developments show. We have reached one of those critical turning points, with markets beginning to acknowledge the inconsistency of recent US monetary policy. Inflating the housing market to sustain the economic recovery will prove little more than a short term panacea to the sluggish growth in real wages. The unrelenting rise in the current account deficit remains *the* major threat to US asset prices.



The US$ And Treasuries

The potential fallout for the US bond market remains troubling. During the US$ crisis of 1987, 10-year yields rose 324 basis points from trough to peak, before the Dow Jones plummeted 22.6% on October 19th of that year. Such extreme moves (in the bond market at least) are unlikely to be repeated this time around. As we have argued before, the underlying inflation dynamics have changed significantly, even if the short to medium-term risks of a spike in the CPI numbers remains high. The world has changed 'structurally' since 1987. Debt levels are so much higher and the economy has been more dependent on credit growth to close a negative output gap. All of this remains inherently bullish for Treasuries on a *secular* view. The shift in fiscal policy stance from overtly stimulative in the first Bush term to moderately restrictive, is also a help.

Nevertheless, the risks for Treasuries once the US$ starts to slide again are clear. The January PPI numbers were exaggerated by some special factors, but the underlying build-up in cost pressures from last year's US$ devaluation - and higher raw material prices - has been self-evident for some months. It is just a question of time before the acceleration in factory gate prices shows up again in the CPI reports, just as it did in the early months of 2004. On that occasion, 10-year Treasury yields jumped 118 basis points, a move that was aggravated by a leap in payrolls. The potential for a similar spike in the employment numbers cannot be ruled out, since the jobless claims data have improved significantly of late.

The key underlying problem, of course, is that the housing boom is driving an unsustainable growth rate of consumer spending, which is putting unrelenting pressure on the external accounts. The growth in import volumes has continued to outstrip the rise in real exports. The differential was -7.0% on a 3m/3m annualised basis in December. The gap was -4.1% comparing Q4 with a year earlier. As the chart on this page shows, there is little reason to expect import volumes growth to slow so long as retail spending remains robust. The chart shows

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import volumes mapped against retail sales excluding autos. This reveals a slightly closer relationship than one comparing imports vis a vis total retail sales, since an increasing proportion of foreign car sales in the US are manufactured domestically. Either way, the differential between export and import volumes is still mired in negative territory, when it needs to be significantly positive just to stabilise the 'real' trade balance, since the absolute level of imports is so much higher to start with. But even a turnaround in these real numbers would not suffice. The J-curve impact has yet to kick in - and when it does - will exacerbate the rise in the nominal trade deficit, a point that Mr Greenspan stressed in his address on February 4th prior to the G7 gathering. Indeed, it should not be forgotten that the real trade balance was actually improving for much of 1987 when the US$ was coming under sustained downward pressure. The tail end of the J-curve effect following the previous two years of US$ depreciation was still putting the headline deficit under upward pressure, and in turn creating further US$ selling. In this sense, it can be seen that the necessary adjustment to the current account deficit has a long way to run and is likely to stretch well into 2006 and possibly beyond.

Indeed, while the December trade numbers were somewhat better than the record shortfall of the previous month, they confirmed we are not even close to a turning point. The goods and services deficit rose 10.4% q/q during Q4, averaging a record monthly shortfall of US$57.3bn. If the invisibles balance was unchanged in the latest quarter, the current account deficit will have risen to an all-time high too, hitting 6.2% of GDP. But of course, there are good reasons to believe the invisibles will widen during 2005. Higher Treasury yields, particularly for shorter maturities, have the potential to inflict significant damage on the net investment income balance. A current account deficit of 7.0% or more at some point this year is very plausible. Until there is discernible evidence that the US authorities are prepared to significantly slow the housing market, it is hard to see why the trade numbers might improve. Ultimately, it may be left to the markets to impose the necessary adjustment to bring the deficit down to manageable levels.

In some sense, none of this is particularly new. Nevertheless, the confluence of this poor external backdrop and the risk that central banks would diversify their reserves this year implied the US$ rally would eventually run out of momentum. The significance of Monday's news from South Korea that its central bank plans to "diversify the currencies in which it invests" should not be under-estimated. Unsurprisingly, the Bank of Korea has tried to play down the importance of the February 18th report to a parliamentary committee, which has sparked the sell-off in the US$ against the won. But the announcement merely corroborates other evidence that central banks are shunning US assets. A recent survey by Central Banking Publications, for example, showed that 39 out of 65 central banks had increased their exposure to the euro last year, while 29 had reduce their US$ holdings.

All this is perfectly consistent with the manner in which the Bretton Woods system broke down in the early 1970s. It may seem irrational for central banks to sell US$ assets since, of course, they will precipitate the very adjustment they have been seeking to avoid from currency intervention in the first place. But in reality, their behaviour is perfectly rational. Faced with such an unrelenting increase in the US current account deficit, a growing number of central banks (with one notable exception in Beijing) are recognising the limits to export-led growth strategies, and accepting some appreciation of their currencies. The Bank of Thailand governor remarked late last year that he was "not worried about the (rising) baht so long as it moves in line with regional currencies". Indeed, he even went on to suggest that a stronger baht would help to control import demand and inflation. It seems some of the lessons from the ‘growth at any cost strategy’ which precipitated the Asian crisis in 1997, have been absorbed. Once central banks start down this path, the temptation to diversify their reserve holdings becomes irresistible, and the potential for a violent decline in the US$ intensifies.