Tortoise QuickTake Credit Podcast

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Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, a senior member of Tortoise provides a timely update on trending topics in the market.

Welcome to the Tortoise Credit weekly podcast. I am Jeff Brothers, Senior Portfolio Manager for Tortoise. In my last podcast, I proclaimed that Goldilocks had returned to the financial markets, but worried how long the good times would last. With the recent escalation in trade tariffs between the U.S and China, it turns out Goldilocks was just visiting. In today's podcast, we will discuss the threat of China using its "nuclear" option in the trade war by dumping its stockpile of U.S. Treasury securities.

The trade brinkmanship or foot shooting, depending on your perspective, took a turn for the worse last week when China announced plans to match the initial $50 billion in proposed U.S. tariffs and President Trump quickly followed with a threat of an additional $100 billion in tariffs. In the context of the two largest global economies, the tariffs, if enacted, are relatively small and should not have a significant impact on global growth. However, given the current intensity of the rhetoric, the risk remains that the tit-for-tat escalation leads to a full-scale trade war.

China currently holds $1.17 trillion in U.S. Treasury debt, which represents approximately 8% of the total debt. The bond markets have long worried about China's role as the largest creditor of the United States. China has accumulated its holdings primarily through reinvesting the dollars acquired through their trade surplus with the United States back into U.S. Treasury debt. China currently runs a $375 billion annual trade surplus with the United States. The rhetoric from China indicates that reducing their reinvestment or perhaps even outright selling their U.S. Treasuries holdings is on the table. China has stated that they do not seek a trade war, but will match any measures with equal intensity and when China's ambassador to the United States was asked whether China would consider reducing Treasury holdings he replied, "We are looking at all options."

Despite the tough talk, we believe China will continue to purchase U.S. Treasury debt. First, China has few alternatives to recycle their dollar surplus that can match the size, liquidity and safety of the U.S. Treasury market. The European and Japanese bond markets are smaller, lower yielding and do not solve the dollar reinvestment issue. Second, if China were to reduce or even signal an intention to cut their holdings of U.S. Treasuries, it would likely result in a sharp rise in interest rates. Higher U.S. interest rates would come at a particularly difficult time for the U.S. bond markets, given the increased borrowing needs from the tax cuts and spending bill and from the unwind of Federal Reserve's balance sheet. The rise in rates, however, would also negatively affect the value of China's remaining Treasury portfolio, potentially losing billions in market value, while providing no benefit to the Chinese economy. Higher rates would also potentially tighten financial conditions and slow global growth, which would hurt China's export-driven economy. Lastly, the decision to reduce Treasury holdings would likely cause China's currency to appreciate against the U.S. dollar. The United States is currently China's biggest trading partner with over $500 billion in exports last year. A stronger Chinese currency versus the dollar would not only hurt Chinese exports, but the weaker dollar would benefit U.S. trade.

We are sensitive to the risk of a major buyer of U.S. Treasuries reducing their holdings. The repercussions from higher interest rates could threaten the U.S. economic recovery and the ability to finance our growing budget deficits. The risks from the Chinese perspective are equally ominous, with the potential for an appreciating currency hurting exports, economic growth and employment. To avoid mutual destruction, we see China's use of the "nuclear" option of reducing Treasury holdings as a threat rather than a possible course of action.

Thank you for listening, and we'll talk to you again next week.

Thank you for joining us. And stay tuned for our next cast. Have topics you want covered or other feedback to share? Write us at info@tortoiseadvisors.com.

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