Tortoise QuickTake Credit Podcast

Tortoise

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Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, 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. The markets were hoping for a quiet week before heading off to Memorial Day barbeques and beer, but instead faced the escalating trade tensions with China. The latest round of tit-for-tat measures included a growing technology cold war as President Trump slapped a ban on Chinese telecom giant Huawei. In today's podcast we wanted to revisit the possibility the next weapon in the trade war might be China's stockpile of U.S. Treasury securities.

As background, China currently holds $1.12 trillion in U.S. Treasury debt, which represents approximately 5% of the $22 trillion of the outstanding U.S. debt market. 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. Treasury holdings is on the table. A Chinese state run newspaper recently reported that, "Chinese scholars were discussing the possibility of dumping U.S. Treasuries and how to do it specifically." Adding to the market nervousness, government data shows that China has reduced their holdings by $63 billion since the trade war began a year ago.

Despite the tough talk, we do not believe China will resort to using their Treasury holdings as the "nuclear" option in the trade war. 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 and do not solve the dollar reinvestment issue. Next, although the return on Chinese reserves may be of secondary importance, the U.S. bond market, with 10-year yields around 2.3%, offers a dramatically higher yield when compared to negative yields in Japan and Germany. In addition, if China were to begin a program of significantly selling U.S. debt, 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 fragile U.S. economy and given the increased borrowing needs from the growing budget deficit. 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.

China does utilize their Treasury holdings to manage and stabilize their currency. The impact of abruptly selling massive amounts of their Treasury holdings would likely cause China's currency to appreciate against the 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. The recent decline of Treasury holdings is probably due to efforts to prop up their weakening currency rather than an attack in the trade war.

Lastly, judging by the recent decline in U.S. interest rates, there continues to be strong demand for the safe, high yielding Treasury market. China's dumping of Treasuries could have a temporary impact of raising rates, but many investors would view this as a buying opportunity and drive rates back down. If the rise in rates tightens financial conditions and threatens the U.S. economy, it is not out of the realm of possibility that the Federal Reserve would reinstitute the quantitative easing program to purchase U.S. Treasuries.

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. We view China's threat of reducing its Treasury holdings as a paper tiger rather than a possible course of action.

Thank you for listening, we will 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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