



When do Treasuries Crash and What Do You Do?

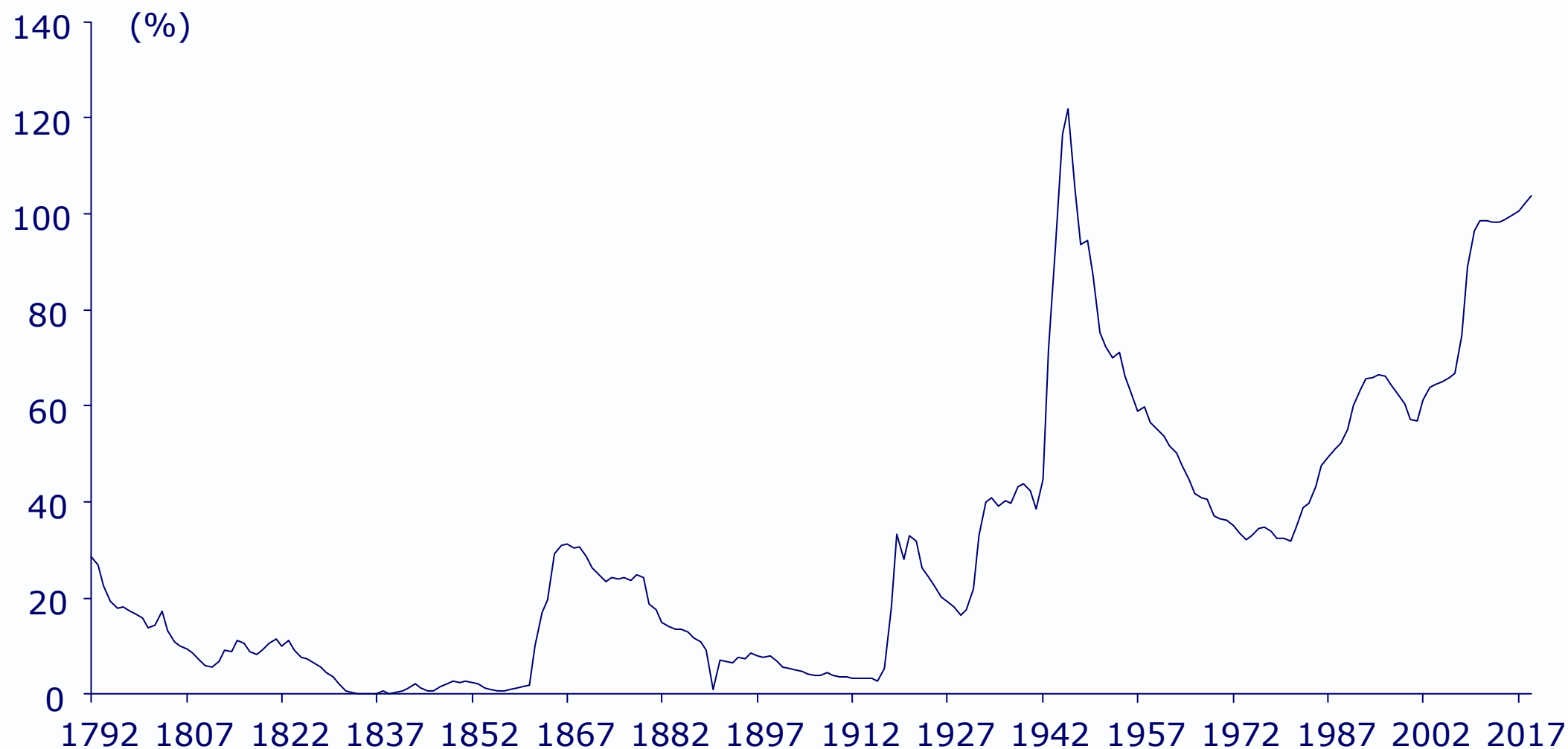
Russell Napier

February 2010

Foreign ownership of US Treasuries



US public debt-to-GDP ratio



An EM Bubble & a Treasury Bubble?

- Net issuance of Treasuries will be around US\$978bn pa
- Capital inflows to emerging world will force their central banks to buy in excess of US\$300bn pa
- US commercial banks can buy more than US\$300bn pa
- Bank credit distorted by Fed's US\$1.2tn purchase of credit assets
- Adjusted for Fed activity there is minor deleveraging only in the US

The great distortion - Foreign central banks

- Treasury holdings increased by US\$502bn in 2009.
- This was due to huge capital inflows, which will not abate
- Balance of payments is key, not current account
- Pension flows and hedge-fund leverage all end up in Treasuries
- For 10 years foreign central banks have bought more than half the net Treasury issuance - this continues for a while

Treasury issuance around US\$978bn pa

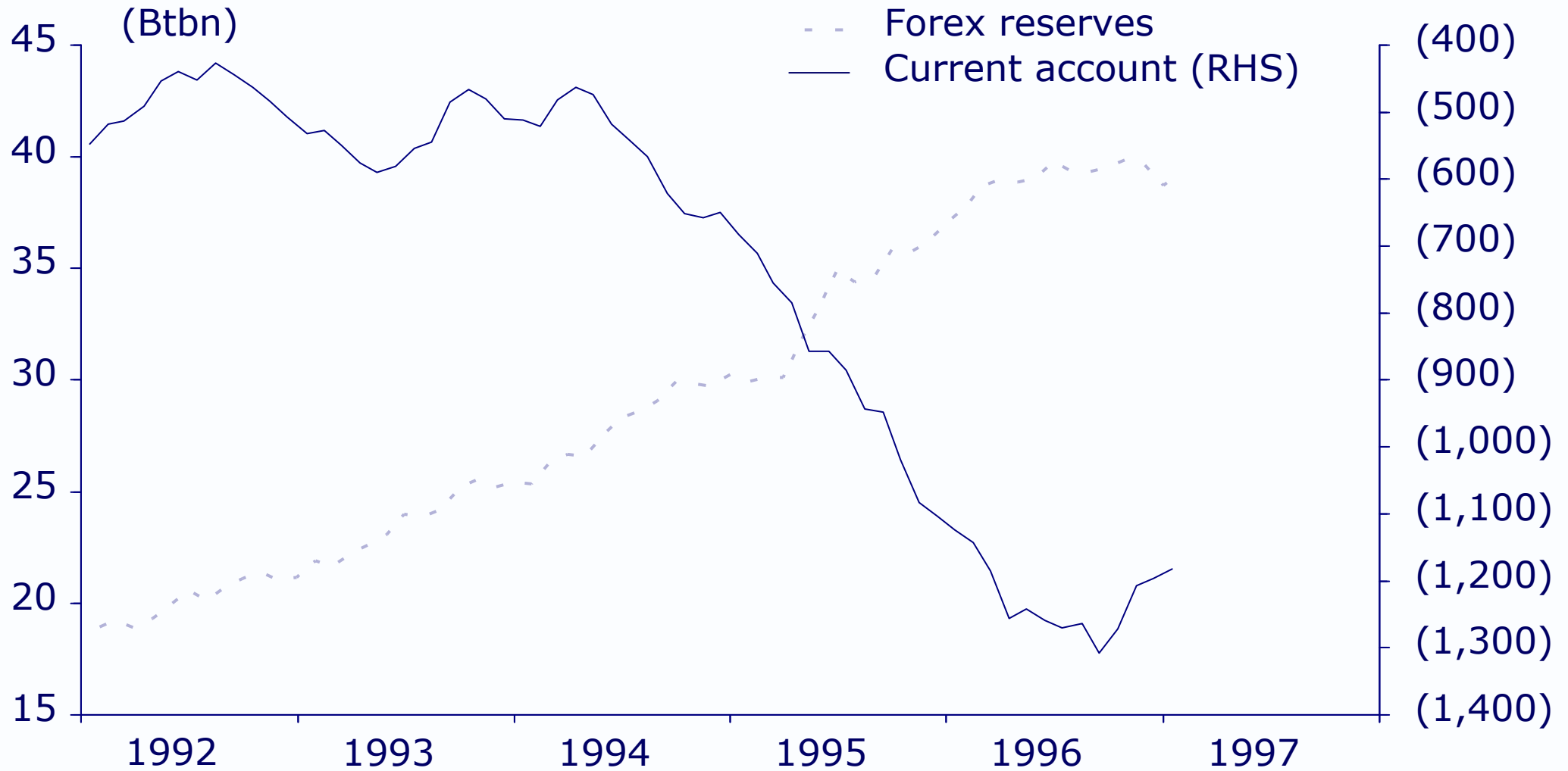
Federal debt 2009-2019 and annual net new issuance

Total Federal Debt	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
	11,901	13,303	14,367	15,170	15,883	16,683	17,484	18,310	19,125	19,778	20,667
Annual Increase		1,402	1,064	803	413	800	801	826	815	653	889
Federal Debt											
Held By Public	7,544	8,797	9,785	10,479	11,556	12,055	12,595	12,581	13,133	13,678	14,329
		1,253	988	694	1,077	499	540	14	552	545	651

Source: Congressional Budget Office

Bigger CA deficits do not mean falling reserves

Thailand's current-account deficit and foreign-exchange reserves



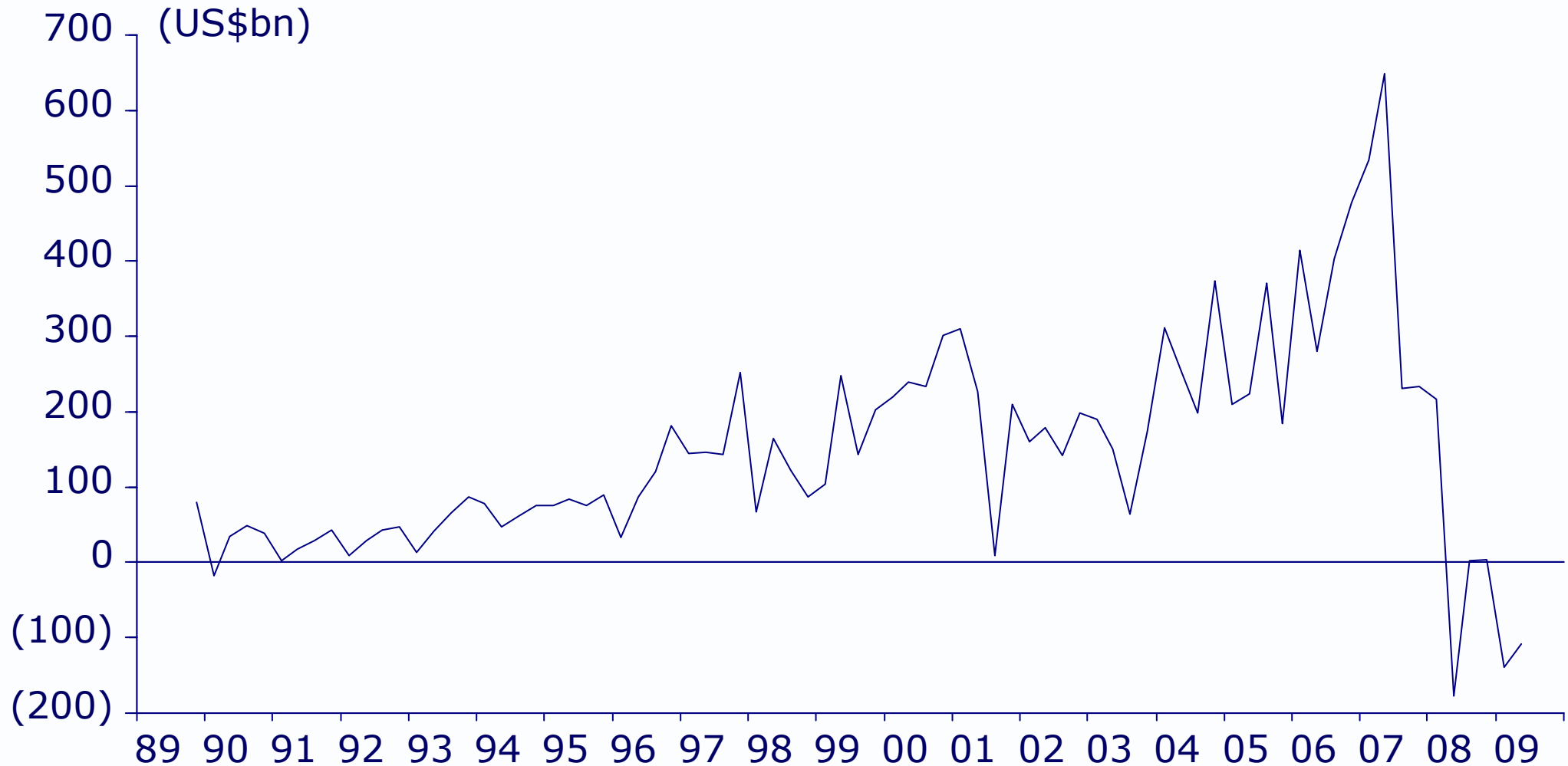
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Asian reserves will grow as capital flows reverse

Private-sector capital inflows to the US, 1989-2009



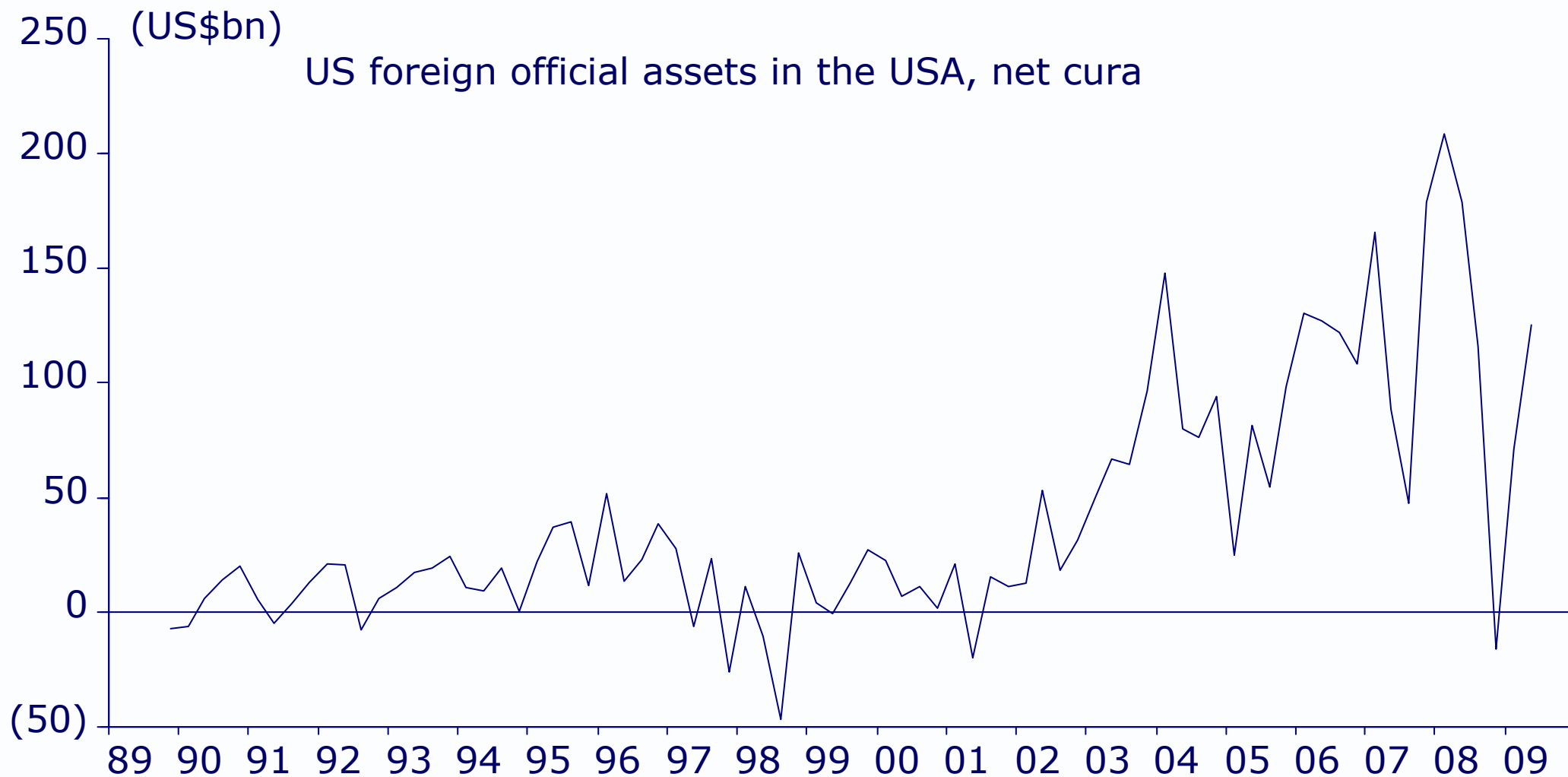
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Foreign central bank flows to US are strong

Quarterly



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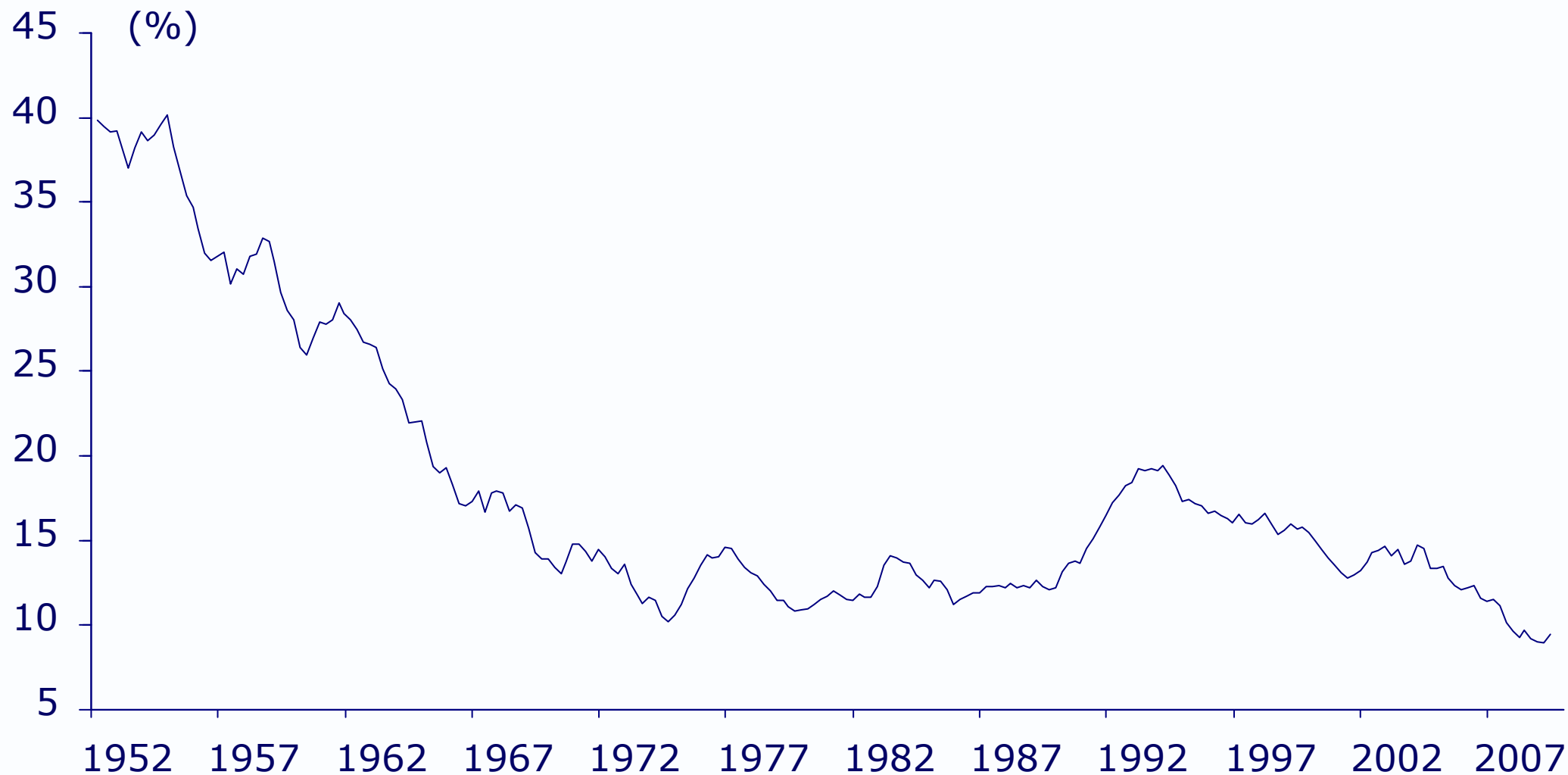
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The great distortion - US commercial banks

- As in 1991-94, banks will buy Treasuries to fix their balance sheets
- A repeat of the 1991-94 rotation would produce US\$1tn-plus buying of Treasuries
- Bank purchases of government debt can reflate America

A US\$1tn-plus purchase of treasuries?

Treasury & agency securities owned as % of bank total assets



Source: Datastream

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Impact of repeat of 1991-94 rotation

- Potential net purchases of US Treasury & agency securities by US commercial banks

(US\$bn)	Current	+5%	+10%	+15%	+20%
+7.3%	860	903	946	989	1,032
to 19.4%	1,222	1,283	1,344	1,405	1,466

Reflating America while bank loans decline

- March 91-May 93 saw no growth in bank loans and leases
- Banks concentrated on buying Treasuries and the non-banking sector financed the private sector
- 16 months with no loan growth and total credit growth was just 6.5%
- GDP expanded by more than 7% and there was a bull market in equities
- Even marginal M3 contraction made no difference

Bank credit contracts but not total credit

US commercial bank credit, assets, loans and total credit outstanding

(US\$bn)	Jul 08	Recent
Total assets	11,058	11,582
Bank credit	9,017	9,008
Loans & leases	6,934	6,676
Total US credit ¹	51,526	52,617

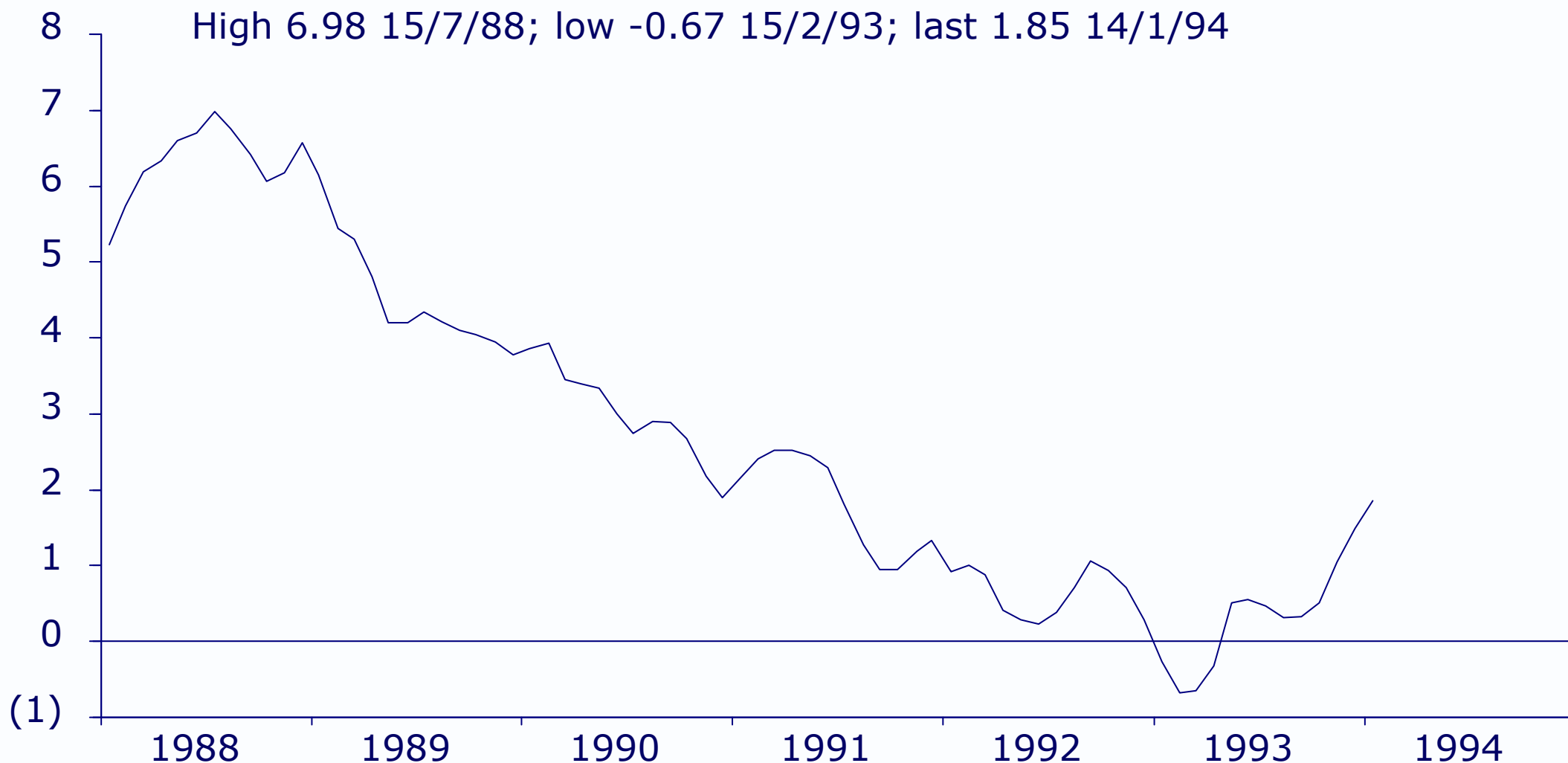
Source: Federal Reserves – H8 Statistics and The Flow of Funds of the United States of America

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M3 contraction and a bull market

US M3 growth, 1988-93 (%)



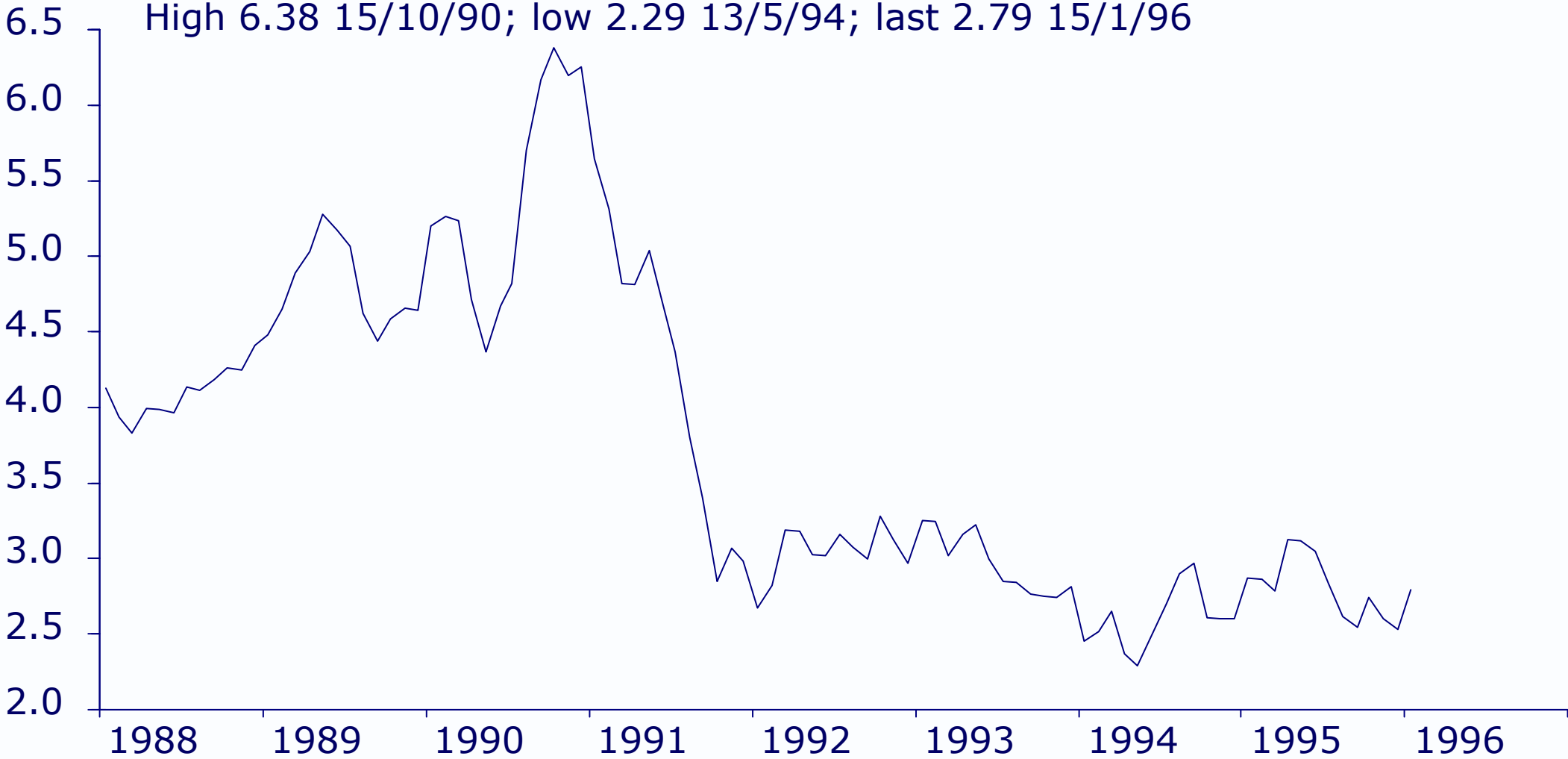
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But will credit demand pick up with lower inflation?

US CPI, 1988-96 (%)



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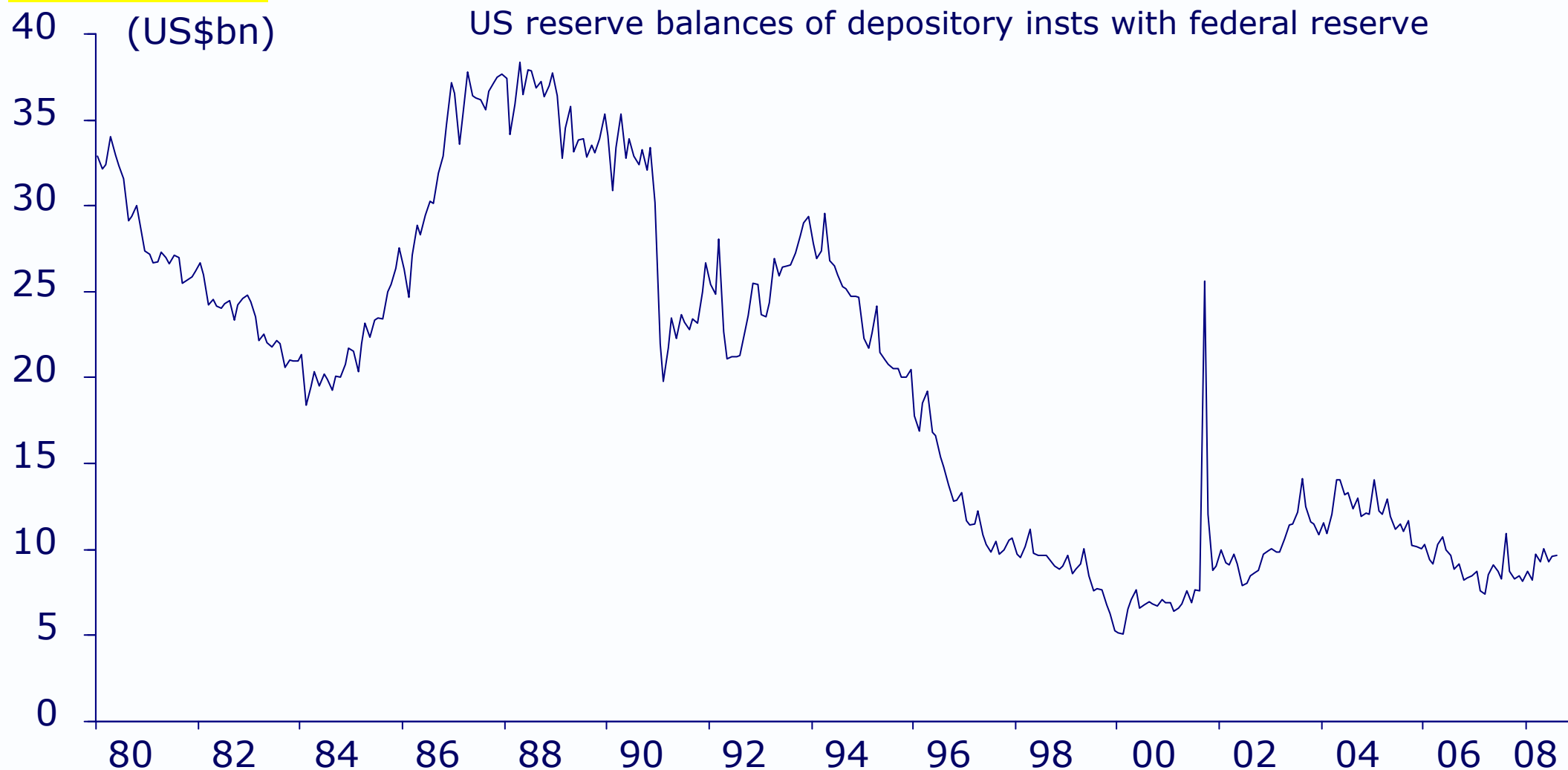


Bank credit stable but distorted

- Bank credit has contracted because the Fed has removed 12% of credit assets from the banks
- The surge in non-borrowed reserves is a unique reduction in bank credit of US\$1.2tn
- Adjusting for the Fed's actions, bank credit growth is not contracting
- In last six months bank credit contraction -0.5%
- Real estate loans are up on Sep 09 levels

Falling reserves the status quo

Reserve balances

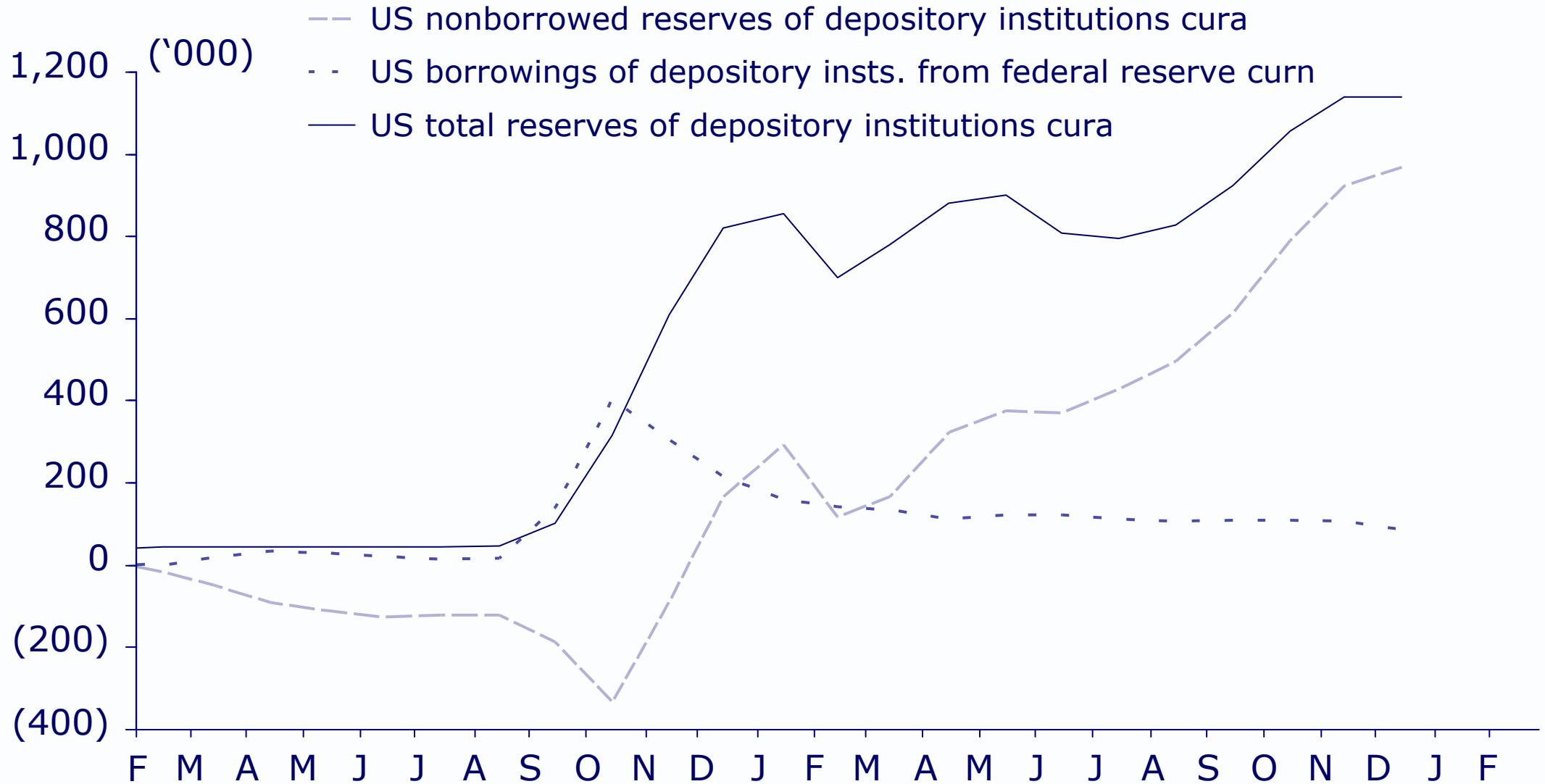


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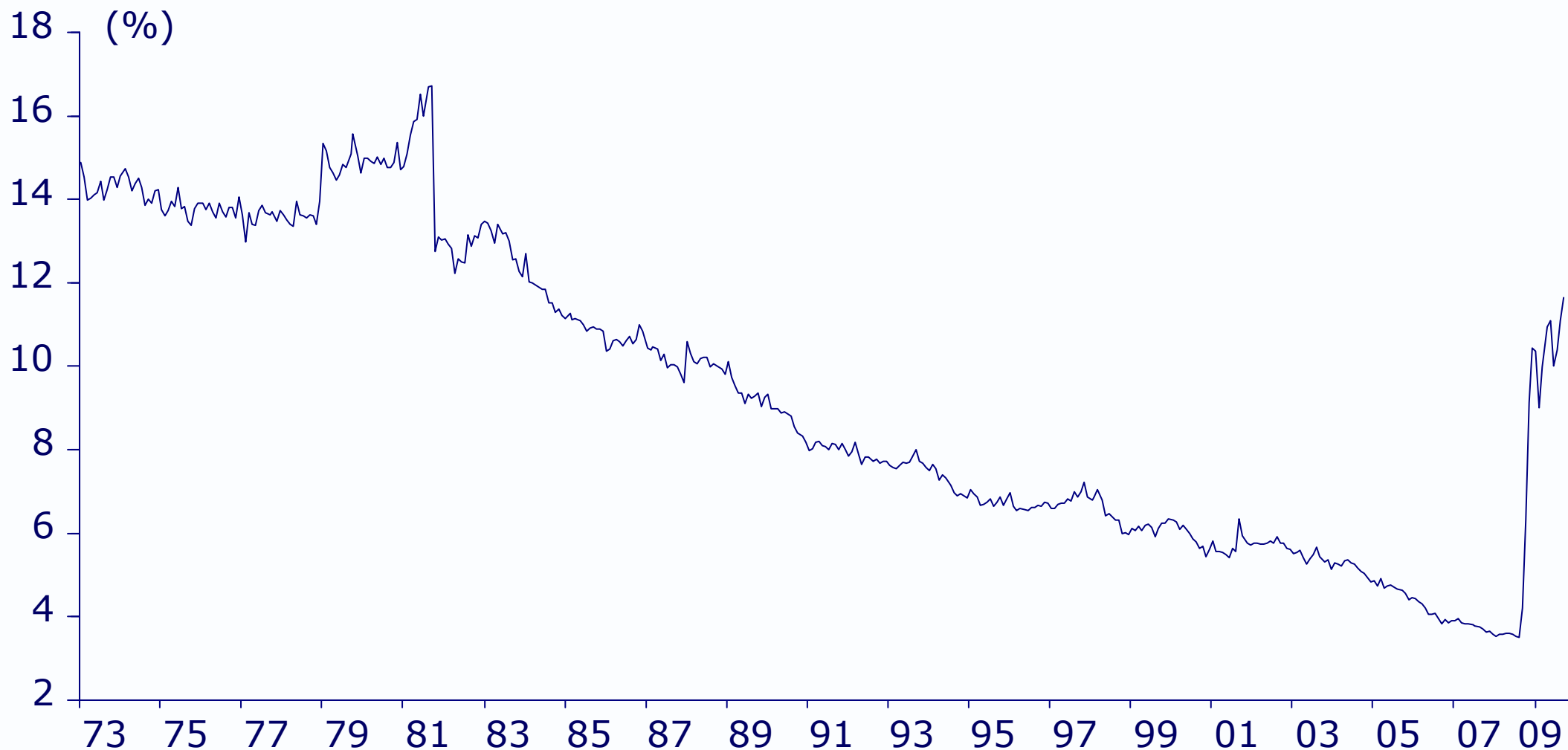
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Reserves continued to rise in 4Q



Unique balance-sheet alteration

US commercial bank cash assets as a % of total assets

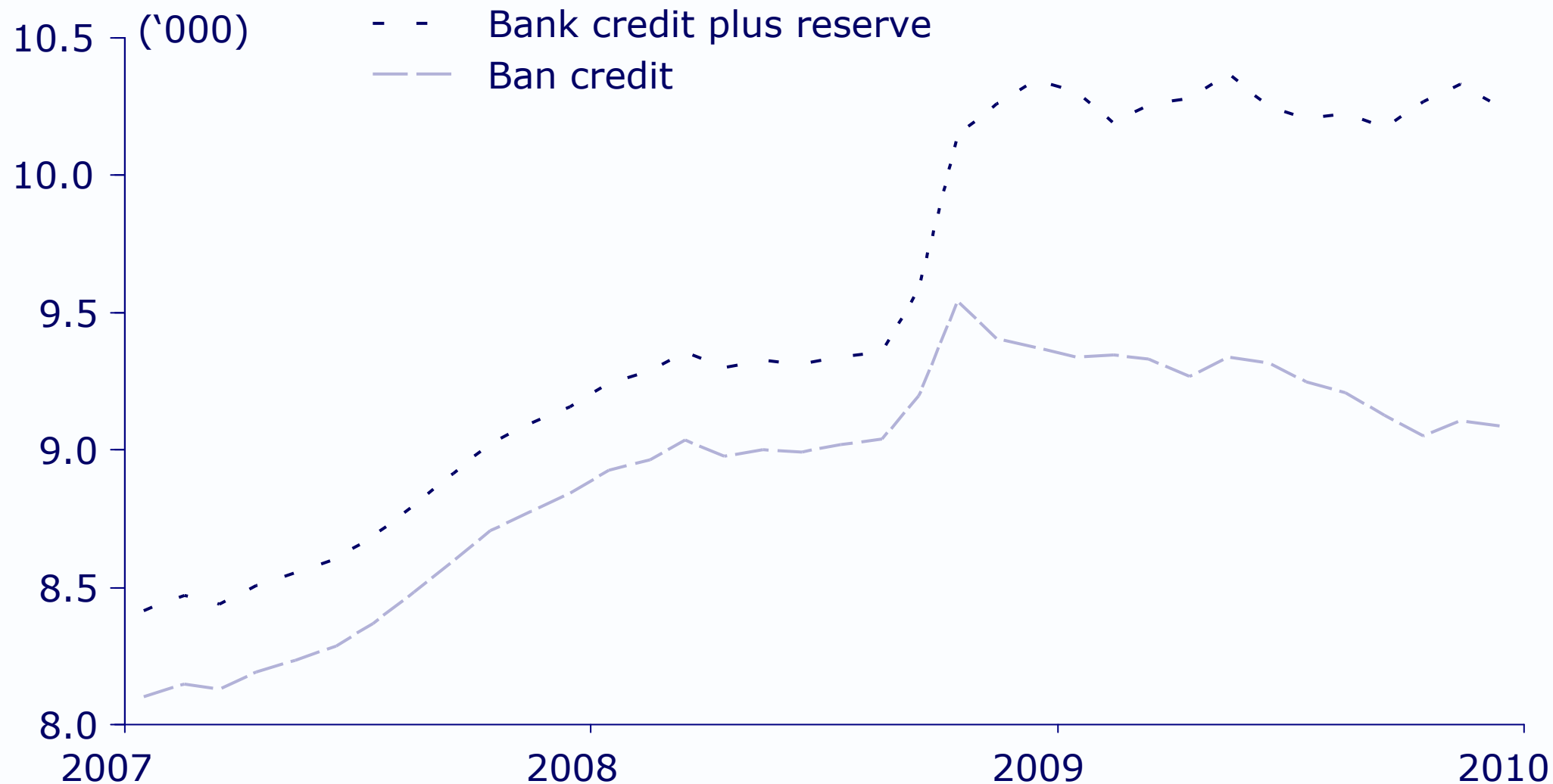


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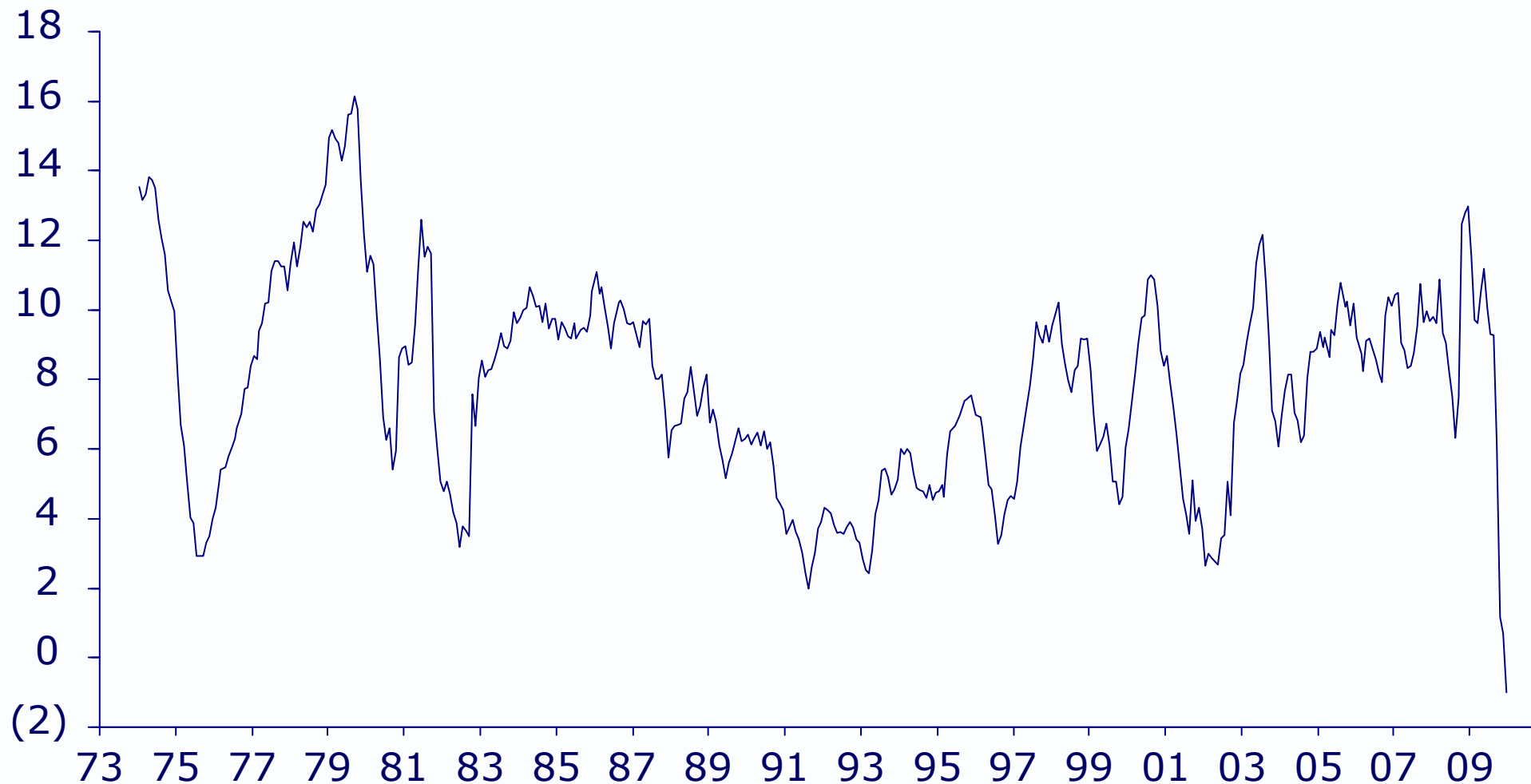
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Adjusted Bank Credit Stable



Adjusted Bank Credit Contracts

Bank credit & reserves (YoY growth) to December 2009

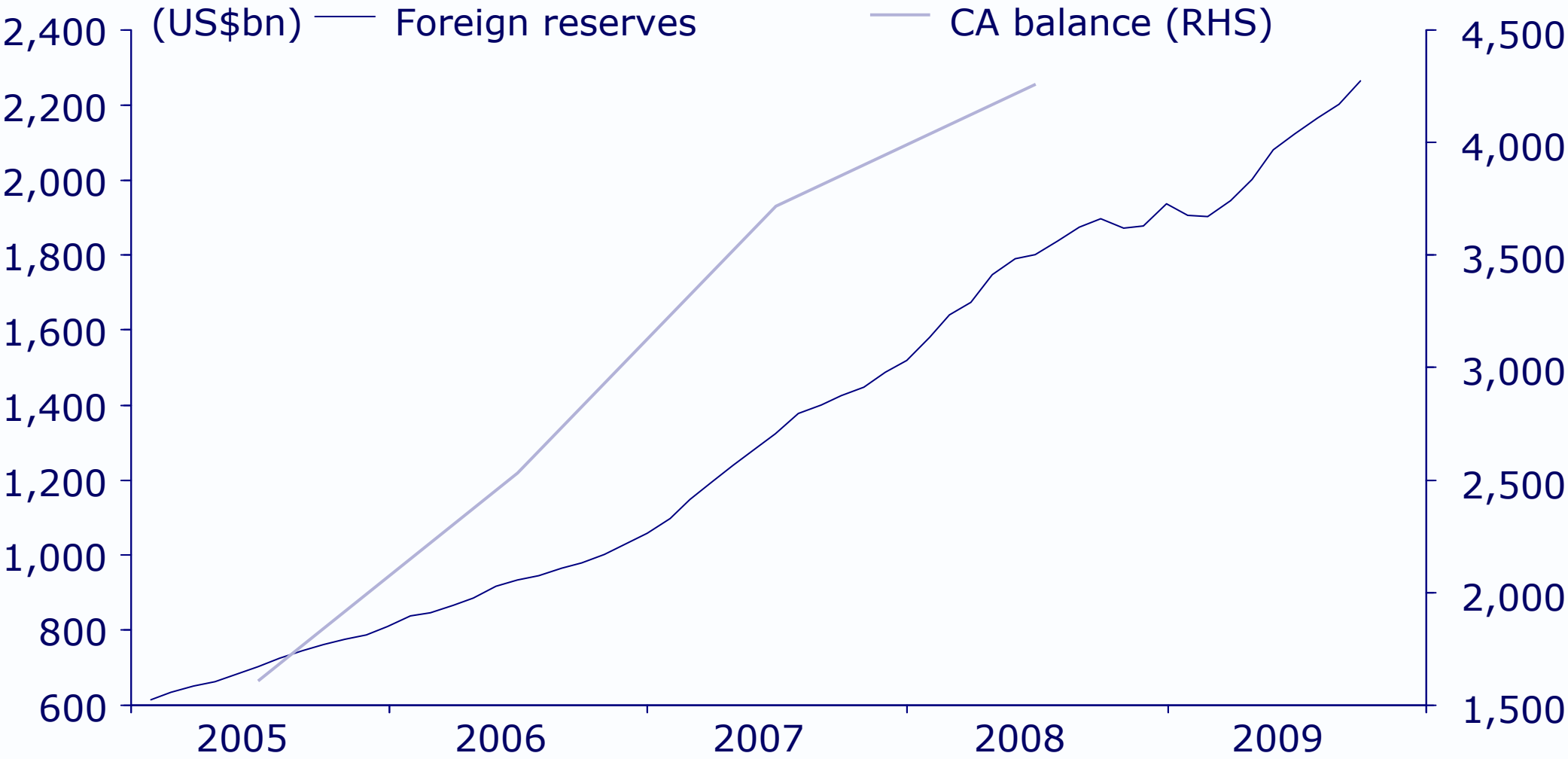


Governments & the great distortion

- China's return to gradual appreciation of the renminbi does not stop funds pouring into Treasuries
- A one-off revaluation was not spurred by 8% inflation in China in 2008 so it will not happen now
- Capital controls are coming in Asia
- Capital controls will be insufficient and credit controls will follow
- Such measures shorten the duration of the great distortion but still current due to CA surpluses

Impact of China's 2005-08 revaluation

China's foreign reserves and current account balance



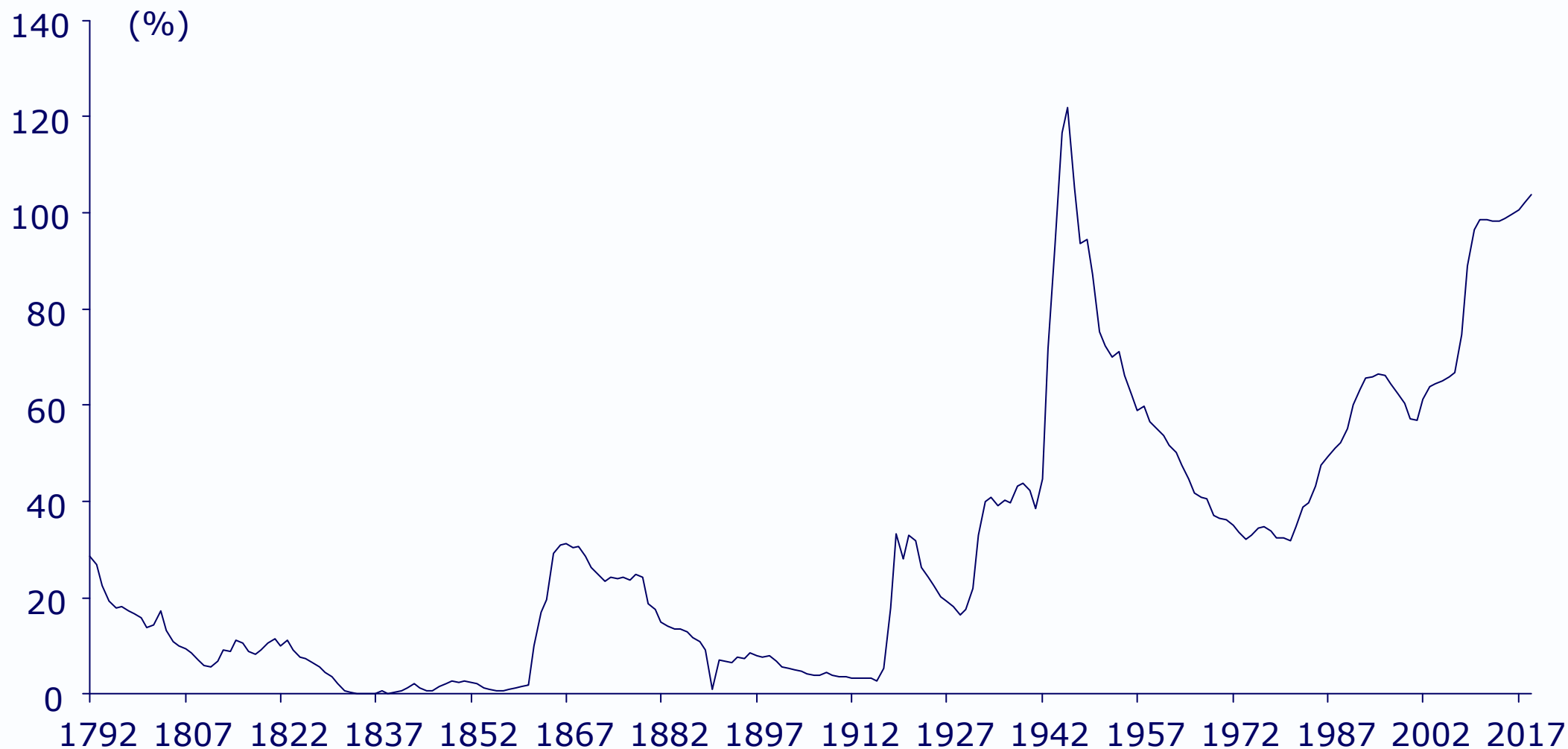
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US public debt-to-GDP ratio



Foreign ownership of US Treasuries



US cyclically adjusted PE - S&P400



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