First Trust
Monday Morning OUTLOOK

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Will Russian Sanctions Lead China to Sell US Debt?

Russia's invasion of Ukraine led western nations to impose the most draconian economic sanctions in the modern era. The Russian stock and bond markets have collapsed, along with Russia's currency, the ruble.

Many investors fear that China, which has always wanted control of Taiwan, will use the mayhem of the moment to take it. Obviously, this would create even more uncertainty and mayhem, but China is more involved in global finance than Russia. The West's response to Russia has not gone unnoticed, but many fear that even if China doesn't invade, it may preemptively sell its roughly $1.1 trillion in US government debt to avoid financial retaliation. The fear is that this will cause US interest rates to soar and the US economy to suffer.

We think this fear is unwarranted. Yes, inflation and Fed tightening are likely to push up rates in the next few years. This is what the markets should focus on, not a Chinese sell-off of US Treasury debt, which would have little impact.

First, total US debt is roughly $30 trillion. If China sold all its debt, it is only 3.6% of all outstanding US debt. A shock to the system maybe, on the day it happens, but just a temporary shock, not a death blow.

Second, consider what's happened to our budget deficit the last couple of years. Right before COVID, the Congressional Budget Office estimated that the baseline deficits for Fiscal Years 2020 and 2021, combined, would be a two-year total of $2.0 trillion. Instead, due to COVID and related shutdowns, the two-year deficit totaled $5.9 trillion. That's $3.9 trillion in extra deficits over a two-year period. And the 10-year Treasury yield is essentially where it was right before COVID hit.

Third, the Federal Reserve shrunk its balance sheet by almost $700 billion (effectively selling debt securities) in 2018 and the first eight months of 2019. Guess what? Interest rates fell.

Fourth, even if rates were to rise, which looks likely no matter what China does, the US economy has rarely been as insensitive to interest rates as it is today. Due to underbuilding going back a decade, there are too few homes in the US. Even if mortgage rates go up, we need more new homes. Higher interest rates might mean a greater appetite for renting versus buying, but rental units have to be built, too. Meanwhile, auto sales are very low due to supply-chain issues. As those issues gradually get resolved, auto sales should increase even if interest rates go up.

Fifth, we anticipate another round of Quantitative Tightening starting mid-year that will eventually be more aggressive than it was in 2018-19, maybe reducing the balance sheet by $100 billion per month. If we're right, that would mean one year of peak QT by the Fed is even more debt being sold than all the debt China owns. And yet, the 10-year yield is still 1.8%. We know the Quantitative Tightening isn't an exact equivalent to China selling debt. But the comparison still puts the size of a potential China selloff in perspective.

Sixth, it's important to remember that China didn't buy our debt as a favor to the US; they bought our debt out of self-interest. Using Treasury debt to back up their currency makes people more willing to use the renminbi. If China's government sells its Treasury debt, that appetite for the relative safety of the dollar won't disappear and citizens in China could offset this sale by buying more dollar-denominated assets.

Seventh, and most important of all, we need to recognize that interest rates are a function of economic fundamentals and expectations about the future, not who is buying and selling how much Treasury debt on any particular day.

If China sells its Treasury debt, it's going to end up getting dollars in return. What will it do with those dollars? Swap them for a different currency…let's say Euros? Then whomever it swaps with will have the dollars. What will they do with those dollars? If China's sales of bonds drive up rates, whoever gets the dollars would likely turn around and buy US bonds. The result? No fewer dollars or bonds in the world.

The US debt that China owns is more problematic for China than it is for the US. Moreover, if China sells US debt because it fears sanctions, then it will likely sell European debt as well. In the end, it's not the US that has a problematic conundrum.

China invading Taiwan would be a horrible event. But the fear of China hurting our economy by selling our debt is overblown.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
3-7 / 2:00 pm	Consumer Credit– Jan	$24.5 Bil	**$20.7 Bil**		$18.9 Bil
3-8 / 7:30 am	Int'l Trade Balance – Dec	-$87.4 Bil	**-$87.4 Bil**		-$80.7 Bil
3-10 / 7:30 am	Initial Claims – Mar 6	217K	**215K**		215K
7:30 am	CPI – Feb	+0.8%	**+0.7%**		+0.6%
7:30 am	"Core" CPI – Feb	+0.5%	**+0.5%**		+0.6%
3-11 / 9:00 am	U. Mich Consumer Sentiment- Feb	61.3	**62.8**		62.8

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.