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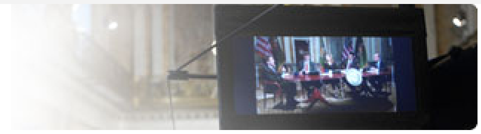

Report to the Secretary of the Treasury from the Treasury Borrowing Advisory Committee of the Securities Industry and Financial Markets Association

2/3/2010

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February 2, 2010

Dear Mr. Secretary:

Since the Committee met in early November incoming data have confirmed a significant acceleration in the pace of economic activity. A recovery initially sparked by aggressive policy stimulus is broadening as the private sector shifts away from retrenchment. This transition is likely to be completed this quarter with resumption in hiring. The prospects for sustaining above-trend growth are good, but the unemployment rate will likely stand above 9% at the end of the year.

With a spike in 4Q09, real GDP grew at a 4% annualized pace during the first two quarters of the recovery. Over one-half of this gain reflects the end of an aggressive liquidation of inventories. However, an upturn in final demand has also been established.   Contributing to the 1.9% annualized increase in final sales during 2H09 were consecutive quarterly gains in equipment spending, exports and personal consumption. The manufacturing sector was a major beneficiary of this turn in demand, producing 7.4% annualized growth – its strongest two quarter gain in almost ten years. A spike in the ISM survey to 58.4 in January bolsters confidence that the manufacturing sector will continue to expand at a rapid pace.

Although the "cash for clunkers" incentive scheme created considerable volatility, consumer spending grew at a 2.5% pace through the second half of last year. Against the backdrop of continued job losses and rising gasoline prices, this outcome marked a shift in behavior as the saving rate ended a sharp upward adjustment. Most growth forecasts anticipate rising saving this year that holds spending gains close to its recent pace, even as labor income gains accelerate.

Corporations have made large strides containing costs and strengthening balance sheets over the past two years. Aggressive job shedding and declines in capital spending have helped maintain profit margins close to historic norms. Firms have also built up large cash reserves and lengthened the average maturity of their debt. As a result, they appear well positioned to generate profits and take advantage of growth opportunities in an expanding economy. To date, the turn in corporate behavior remains tentative as inventories and employment have stabilized but are not yet expanding. Equipment and software spending rose an impressive 13% annualized pace last quarter, but remains below levels of depreciation.

Alongside improvement in private sector activity, the benefits of the ARRA stimulus package are starting to wane. During the first half of this year, this package will have little direct impact on US growth and may turn to a drag during the second half. There are, however, initiatives working through Congress that could add as much 1% to GDP.   No meaningful fiscal consolidation is expected this year and the 2010FY Federal budget deficit is likely to remain stable at about $1.5 trillion (9.4% of GDP).

Year-ago changes in consumer prices should move towards 3% early this year, as food and energy prices have increased sharply from their recession lows. Underlying price pressures likely will remain quiescent. Multi-decade highs in unemployment and rental vacancy rates are set to restrain core inflation, which will remain below the Fed's target level this year. Alongside above-trend growth and the continued improvement in financial market conditions, the Federal Reserve will likely unwind its unconventional policy tools – including the ending of the purchase of agency mortgage-backed securities.   However, with core inflation low and unemployment high, it is unlikely that policy rates will be increased anytime soon.

In the aftermath of the four prior deep downturns of the past sixty years, US GDP has grown at more than 6% percent for a full year, lifted by many of the same cyclical forces currently in place. The turn in business spending and hiring could be particularly forceful this cycle, given the severity of prior retrenchment, the early recovery in margins, and the reduction in corporate bond yields over the past several months. There are, however, unique drags in place that will temper lift. Financing problems for small firms without access to the credit markets should restrain the business upturn, particularly as small companies tend to be an important engine of job creation in the early stages of expansion. Intense pressure on state and local finances should also limit spending and hiring. Depressed housing markets and concerns about job security will weigh on household sentiment. More generally, uncertainty about the tax and regulatory environment could weigh on business decision making. The economy's realized performance will reflect the outcome of the tension between powerful cyclical lifts and unique drags.

Against this economic backdrop, the Committee's first charge was to examine what adjustments to debt issuance, if any, should Treasury make in consideration of its financing needs. The Committee felt that in the near term, no meaningful change in the issuance schedule was necessary. Given the uncertainty around fiscal deficit projections, members felt it was important to maintain maximum flexibility. There was recognition that if the OMB's fiscal year 2010 deficit forecast was accurate, coupon auction sizes would need to come down. However, all felt that maintaining the current auction schedule was appropriate. One member commented that it was important to keep Treasury bills as a percentage of marketable debt at its current level. There was concern that a meaningful drop would hamper liquidity in the bill market. Given an anticipated increase in the debt ceiling, growth in SFP (Supplementary Financing Program) bill issuance would serve the dual purpose of helping to improve liquidity in the bill market, as well as removing excess reserves from the system. There was no discussion of the TIPS market. There is an expectation that TIPS as a percentage of marketable debt would increase over time.

The second charge was to examine how, if at all, the structure of demand for Treasury debt is changing. The presentation highlighted that while foreigners continue to be the largest holders of US Treasury debt, US households and the Federal Reserve have increased their holdings in 2009 (please see attached). Committee members discussed the probable shift in purchases by domestic depository institutions and asset managers, out of Agency mortgages and into US Treasury debt. As the supply dynamics shift from the former to the latter, Treasury debt will be a higher proportion of broad market fixed income indices, thereby attracting demand. Members remarked that longer duration Treasury debt, at yields above LIBOR, offered long-term value. Others mentioned that in contrast, Agency mortgages offered less value given their negatively convex characteristics.

The third charge was to assess the challenges faced by global sovereign borrowers over the short-, medium-, and long-term. The presentation highlighted that budget deficits, as a percentage of GDP, are highest in developed economies (please see attached). The member illustrated that in the past the US, UK, and Japan had successfully addressed large deficits. In these particular cases, fiscal restraint aided by foreign exchange depreciation, easier monetary policy, and strong global growth served to contain liabilities as a percentage of GDP. When examining sovereigns today, the member noted that countries such as Greece and Spain lack both currency and monetary policy flexibility. Furthermore, for all sovereigns, the prospect of slower global growth, already easy monetary policy, and what seems to be a lack of political will make the task of deficit reduction a more daunting challenge.

In the final charge, the Committee considered the composition of marketable financing for the remainder of the January-March quarter and the April-June quarter. The Committee's recommendations are attached.

Respectfully Submitted,

Matthew E. Zames, Chairman

Ashok Varadhan, Vice Chairman