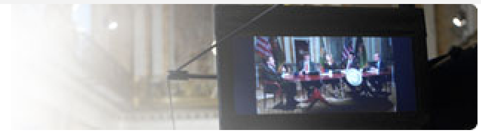
U.S. DEPARTMENT OF THE TREASURY

Press Center



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

2/1/2012

January 31, 2012

Dear Mr. Secretary:
Since the Committee last met in early November, economic activity has continued to expand, and real GDP increased at a 2.8% annual rate in the fourth quarter, the fastest pace of growth in over a year. The acceleration in activity last quarter was supported by a rebound in stockbuilding, as businesses returned to building up inventories following the more cautious attitude displayed in the third quarter. Inventories added 1.9%-points to last quarter's gain in output, following a third quarter in which stockbuilding subtracted 1.4%-points from growth. The lift from replenishing lean stocks helped support manufacturing production, which expanded at a 3.9% annual rate in the fourth quarter.

With inventories now better aligned with final sales, the support to industry from a positive turn in the inventory cycle will likely diminish. In addition, slowing global growth may exert a damping effect on US factory output. Despite these headwinds, early manufacturing surveys for January suggest the factory sector is faring well early in the year. Automaker production schedules indicate that this key sector should continue to expand in the current quarter.

Real consumer spending increased at a 2.0% annual rate last quarter. Spending growth was particularly strong for consumer durables; a normalization of auto and truck inventories after the Tohoku earthquake supported vigorous growth in light vehicle sales, which climbed to a 13.6 million annual pace of sales by year-end. Modest but steady gains in labor income are providing support to consumers. Employment has increased by 137,000 jobs per month on average in the fourth quarter, and the average work week increased last quarter after declining in the third quarter. Consumer spending was also supported by a decline in retail gasoline prices, undoing some of the drag on purchasing power witnessed earlier in 2011. Even so, the holiday shopping season was a modest disappointment. One possible explanation is that households are seeking to bring saving rates back up, after lowering saving earlier in the year to smooth consumption growth in the face of the hit from higher energy prices. So far, indicators regarding consumer spending in early 2012 are mixed.

After growing vigorously for much of the expansion, real business fixed investment spending cooled off to a 1.7% pace of growth last quarter. Real outlays for equipment and software expanded at a trend-like 5.2% annual rate. Meanwhile, business spending for structures surprisingly declined at a 7.2% rate. Spending on mining-related structures fell off sharply, as lower natural gas prices have reduced the economic feasibility of capital spending in this area. Residential investment, however, expanded at a 10.9% pace. While housing indicators generally remain mixed, there have been some encouraging signs recently, particularly a jump in homebuilder sentiment. Mortgage rates have recently fallen to new all-time lows, providing an important support to housing demand.

Declines in real government spending continue to drag on overall economic growth. Real government outlays declined at a 4.6% annual rate last quarter. The decline was exaggerated by a big drop in the volatile defense spending category. While this decline may be partly reversed in coming quarters, real defense outlays are generally set to trend lower. Real outlays by state and local governments declined at a 2.7% rate, the 13th decline in the last 16 quarters. Late last year, policymakers extended expiring payroll tax and unemployment benefit provisions. Those programs are now extended through late February, and most analysts expect they will be extended through year-end.

Real exports expanded at a 4.7% pace, the same as in the third quarter. However, growth in foreign markets has slowed decisively, from Europe to large Emerging Market countries including China and Brazil, and this slowdown should be expected to restrain export growth before long. While the trade spillovers from slower European growth are likely to have a negative effect on the US economy, sentiment regarding financial spillovers has improved recently, as aggressive actions by the ECB to provide liquidity to the banking system has helped to stabilize the sovereign debt crisis.

Inflation has moderated in recent months, largely due to a decline in energy prices. In the three months ending in December, the PCE price deflator increased at only a 0.1% annual rate. Outside of food and energy, core consumer prices increases have also been modest as the core PCE deflator increased at a 1.4% annual rate in the past 3 months and 1.8% over year ago. The easing in commodity prices has taken some pressure off of core goods prices, and the normalization of vehicle inventories has allowed vehicle prices to cool off after surging earlier in 2011. Even though the unemployment rate fell by a half percentage point last quarter, wage inflation remains subdued:

average hourly earnings are up only 2.1% on a year-ago basis. Contained labor costs should continue to limit the pace of consumer price inflation.

Monetary policy has remained active. At the January FOMC meeting, the Federal Reserve unveiled new Committee forecasts for the path and timing of interest rates. Moreover, the FOMC statement pushed back the guidance on the time for the first rate hike, from mid-2013 to late 2014 at the earliest. The revised guidance has further served to keep interest rates quite low. For now, it would appear the Fed has exhausted their options for easing policy through communications. The prospects for further asset purchases remain in flux. Committee members have publicly expressed differing views on the desirability of such action. But, importantly, Chairman Bernanke's comments in the Q and A following his recent press conference lowered the bar considerably for further Fed asset purchases.

Against this economic backdrop, the Committee's first charge was to examine what adjustments to debt issuance, if any, Treasury should make in consideration of its financing needs. The Committee did not feel that any changes to Treasury coupon issuance were necessary at this time.

There was a lengthy discussion regarding the bid-to-cover ratios at recent Treasury bill auctions. It was broadly agreed that flooring interest rates at zero, or capping issuance proceeds at par, was prohibiting proper market function. The Committee unanimously recommended that the Treasury Department allow for negative yield auction results as soon as logistically practical.
The second charge was to explore the viability of Treasury issuing floating rate notes (FRNs). In particular, the presentation [attached] assessed potential client demand, optimal maturity, reference index, and reset frequency. The structural decline in the stock of global high-quality government bonds, coupled with an increase in demand for non-volatile liquid assets, should make U.S. government issued FRNs extremely attractive. Pricing for a hypothetical two year FRN was estimated to be in the arena of 3 month Treasury bills plus 8 basis points.

A discussion then ensued over whether 3 month Treasury bills or Fed Funds Effective was the more appropriate floating rate index. In conjunction with fixed-rate issuance, FRNs give Treasury an attractive alternative to increase the average maturity of its debt. While more analysis on the specifics of the program must be done, the Committee was unanimously in favor of Treasury issuing FRNs.

In the final charge, the Committee considered the composition of marketable financing for the remainder of the January 2012 to March 2012 quarter and the April 2012 to June 2012 quarter. The committee's recommendations are attached.

Respectfully,

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Matthew E. Zames
Chairman

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Ashok Varadhan
Vice Chairman

TBAC Recommended Financing Table Q1 2012 & TBAC Recommended Financing Table Q2 2012