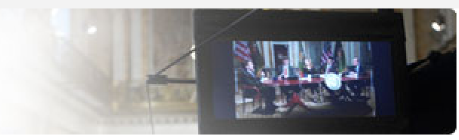

Report to the Secretary of the Treasury from the Treasury Borrowing Advisory Committee of the Securities Industry and Financial Markets Association

8/1/2012

July 31, 2012

Dear Mr. Secretary:

Since the Committee last met in early May the pace of expansion has downshifted, as real output grew at only a 1.5% rate in the second quarter, following a 2.0% pace of growth in the first quarter. This slowdown has been accompanied by a worrisome deceleration in employment; on average only 75,000 jobs per month were created in the second quarter, after the first quarter's more respectable 226,000 monthly pace. The sudden slowing has been blamed on several factors. Unseasonably warm weather may have pulled forward activity into the winter months at the expense of the spring and summer. Uncertainty regarding the domestic fiscal outlook and the European debt crisis are likely adversely affecting business attitudes. Finally, a period of pent-up demand in hiring and capital spending may have petered out of its own accord, giving way to more subdued growth. Although economic developments have been disappointing, the weekly and monthly economic reports point to slow growth, but nothing worse. Most forecasters anticipate the economy will continue to expand modestly in the third quarter.

Real consumer spending increased at only a 1.5% pace last quarter, even though real disposable income expanded at a 3.3% rate. Apparently households took advantage of the decline in energy prices to increase saving rates, which had fallen sharply over the course of prior quarters. The softening in the pace of nominal labor income growth may have contributed to the more cautious attitide on the part of consumers. Looking forward, the lagged effect of the decline in gasoline prices could provide some tailwind to consumer spending, and the stabilization of house prices has buttressed household balance sheets, but ultimately an improvement in labor income growth will be necessary for consumers to make a healthy contribution to final demand growth.

The pace of corporate capital spending growth remains solid, but has decelerated from more rapid gains earlier in the expansion. Real business fixed investment outlays increased at a 5.4% annual rate in the second quarter after growing at a 7.5% pace in the first quarter. The deceleration was due to spending on nonresidential structures downshifting from a 12.9% pace to a 0.9% rate – a step-down that may owe in part to swings in the weather. Spending on real equipment and software increased at a 7.2% pace last quarter, a modest acceleration from the 5.4% growth registered the prior quarter. New orders for capital equipment have turned down lately, raising some concerns about whether the solid gains in equipment spending will persist into the second half. Moreover, some surveys of business spending intentions have signalled that the pace of investment outlays may slow some in coming months. Separately, it appears that the shortfall in final demand last quarter may have left businesses with more inventories than anticipated, as real inventories were accumulated at a $66 billion rate last quarter – a rapid pace that will likely slow in the second half as businesses pare unwanted stockpiles.

Homebuilding and related activity remains a bright spot for the economy, as residential investment expanded at a 9.7% pace last quarter and has increased in each of the past five quarters. Home sales generally continue to move forward – albeit unevenly – and surveys indicate improving confidence among realtors and homebuilders. One of the more promising elements in the recent dataflow has been the continued signs of improvement in house price measures. This should, over time, make its way into potential homebuyer expectations for future house price appreciation, thereby further supporting housing demand.

Real government outlays continued to contract in the second quarter, declining at a 1.4% annual rate. Spending at the state and local level fell at a 2.1% pace, the eleventh consecutive down quarter, and outlays at the federal level declined modestly. Over the past year defense outlays have fallen 4.0%, the most since the early 1990s when the end of the Cold War led to large declines in defense spending. Fiscal policy remains a source of uncertainty in the economic outlook, as the "fiscal cliff" comes closer into view. Although concerns surrounding the cliff have increased, action to address this impending fiscal tightening are unlikely to occur until after the November election.

Thus far, the global growth slowdown has spared U.S. exporters, as exports expanded at a 5.3% rate in the second quarter, after increasing at a 4.4% pace the prior quarter. Surveys of manufacturers point to more subdued growth in industrial output in the third quarter, and the external environment is commonly noted as the largest headwind to the factory sector. Even so, the European sovereign debt crisis has not materially tightened credit conditions in the U.S.

After a good start to the year, the labor market has once again become a source of concern. The unemployment rate fell 0.8%-point in the six months ending in March, but has since held relatively steady at 8.2%. The softening in the labor market has also hit nominal labor incomes, and wages and salaries grew at only a 3.4% rate last quarter after expanding at a 7.6% pace in the first quarter. Any pick-up in consumer spending from the anemic second quarter showing will require some firming in the growth of labor income. The jobless claims data have been particularly noisy in recent weeks, and business surveys do not point to any material change in hiring attitudes relative to the current subdued pace.

Consumer price inflation has eased recently, largely due to declining energy prices. The headline PCE price index advanced at only a 0.7% annual rate in the second quarter, down from the 2.5% inflation rate seen in the first quarter. The ex-food and energy core PCE rose at a 1.8% pace in the second quarter, and has been growing at a similar pace over the past year. Core inflation has continued to run close to the Fed's 2.0% goal. Wage inflation remains subdued and inflation expectations appear well-anchored. Commodity prices may have diverging influences on consumer price inflation in coming months; while industrial commodity prices have moved lower in the wake of the global slowdown, prices for some agricultural commodities have been lifted by drought conditions in the US. On balance, headline inflation should remain modest in the second half of the year.

Since the Committee last met, the FOMC has extended the Maturity Extension Program (Operation Twist) through year-end, and stated that it will take "further action as appropriate" to fulfill its mandate. Since that statement was made at the June meeting, data have continued to print on the soft side, fuelling speculation that the Fed will do something at an upcoming meeting to stimulate growth. At the semi-annual monetary policy testimony before Congress, Chairman Bernanke highlighted communications and asset purchases as the two major tools the Fed could employ if it decides that the speed of the recovery is inadequate for making progress towards full employment.

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 immediate changes to Treasury coupon issuance were necessary. Yet, the evolution of the Fed's Maturity Extension Programs (MEP) warrants increased issuance to the public sector. We examined this more closely in the second charge.

Separately, the Committee again discussed Treasury's capability to auction bills at negative yields. The Committee unanimously felt that Treasury should move as quickly as possible towards implementation. We further discussed the prospects for a Floating Rate Note (FRN) program. TBAC was unanimous in its support for the introduction of an FRN program as soon as operationally possible. Members felt confident that there would be strong, broad-based demand for the product. A dialogue ensued about which floating rate index should be used. The Committee gravitated towards referencing treasury general collateral, in lieu of federal funds effective and T-bills. The introduction of GCF futures aided the argument.

The second charge was to examine the impact of the Federal Reserve's MEP on Treasury's borrowing needs. The presentation, [attached], highlights how the Federal Reserve's sales associated with MEP transferred the maturing stock of debt held by the Fed to private investors. Whereas the Fed had, as a matter of practice, reinvested those proceeds in subsequent Treasury auctions, Treasury must now issue that debt to the public to remain cash neutral. For fiscal years 2012-2016, this sums to $667 billion. A discussion followed about the composition of the additional needed issuance. TBAC agreed that maintaining flexibility, given the uncertainty surrounding the fiscal outlook, was critical. Furthermore, the Committee continues to be committed to lengthening the Weighted Average Maturity (WAM) of its debt. Hence, we felt a combination of larger T-bill issuance, FRNs, and a modest increase in coupon issuance was appropriate.

The third charge was a detailed examination of the Department of Education's federally funded student loan programs. Subsequent to 2010, all federal student loans are now funded by Treasury. The presentation, attempts to encapsulate the anticipated, growth in size, credit quality, duration, and convexity of these loans. A discussion ensued about what liability structure Treasury should employ to fund these assets. Separately, TBAC expressed concern about what incentives these programs create in the field of higher education. Given that the program is fairly new, in time, more empirical data will help shed light on both the nature of the asset and liability management.

In the final charge, the Committee considered the composition of marketable financing for the remainder of the July 2012 to September 2012 quarter and the October 2012 to December 2012 quarter. The committee's recommendations are attached.

Respectfully,

Matthew E. Zames
Chairman

Ashok Varadhan
Vice Chairman

TBAC Recommended Financing Table Q3 2012 and TBAC Recommended Financing Table Q4 2012