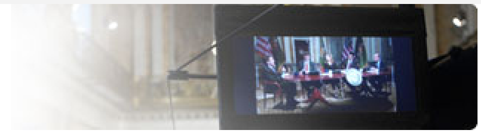
U.S. DEPARTMENT OF THE TREASURY

Press Center



Report to the Secretary of the Treasury

5/1/2013

April 30, 2013

Dear Mr. Secretary:

The economy grew at a moderate pace in the first quarter: real GDP expanded at a 2.5% annual rate, as some of the temporary drags that held growth to a 0.4% pace the prior quarter faded. The tone of the data late in the first quarter softened, quite likely due to the delayed effect of fiscal restraint enacted at the beginning of the year. That restraint is expected to present a significant headwind to growth in the second quarter, as the drag from sequestered federal spending is added to the drag from higher payroll and income taxes. While recent data point to a deceleration from the first quarter's respectable growth rate, there are some supports to growth as well. The housing sector appears set to contribute to overall economic growth once again, and the recent decline in energy prices should provide some purchasing power relief to the household sector. Outside of commodity prices, financial conditions have been mixed but broadly remain supportive of continued economic expansion.

Some of last quarter's solid growth reflected temporary factors. Inventories contributed 1.0%-point to GDP growth last quarter, in part because farm inventories continued to be rebuilt after last year's devastating drought. Partly offsetting this support, government spending was once again a significant drag on overall growth, subtracting 0.8%-point from GDP. Defense spending contracted at a 11.5% annual rate after falling at a 22% pace the prior quarter – the largest two-quarter drop in defense spending since the end of the Korean War.

Real consumer spending expanded at a 3.2% rate in the first quarter, the fastest pace in over two years. Real spending on consumer services rose at a 3.1% rate, the fastest in the expansion, as outlays for utilities jumped due to colder-than-normal temperatures which prevailed through much of the country. After exhibiting surprising vigor at the beginning of the quarter, retail spending appears to have lost steam toward the end of the quarter, likely reflecting a delayed response to the increase in payroll and income taxes enacted at the start of the year. Looking forward, the personal saving rate remains depressed, perhaps indicating an incomplete spending adjustment to the higher tax rates. However, consumers should be the beneficiaries this quarter of a material lift to purchasing power from the decline in energy prices.

The housing market continues to experience a vigorous recovery. Residential investment increased at a 12.6% annual rate last quarter, and the latest building permits data point to continued strong activity growth in the second quarter. House prices continue to move higher in almost all major metropolitan areas.

After expanding at a rapid 13.1% annual rate in the fourth quarter, real business capital spending cooled to a 2.1% pace last quarter. Spending on structures was about flat, while real outlays for equipment and software fared somewhat better, growing at a 3.1% pace. The recent data on orders and shipments for capital goods suggests second quarter business investment spending will expand, but at a fairly modest pace. Capital spending fundamentals remain solid, as profitability remains strong and the cost of capital is low. However, slower consumer spending growth and a more restrained global growth outlook may be imparting some caution into business spending decisions. The slower pace of capital spending is likely a factor in the downshift in industrial activity growth signaled by recent manufacturing surveys.

Exports recovered somewhat in the first quarter after contracting in the prior quarter, though on net, trade subtracted 0.5%-point from growth last quarter. Soft foreign demand growth remains a challenge for US exporters: Europe appears to remain mired in recession, and growth in Asia has weakened some.

Labor market activity has generally remained solid, though net job creation slowed to a disappointing 88,000 in March, heightening concerns about the sustainability of the strength seen in prior months. The recent weekly data on jobless claims, however, have not pointed to any material deterioration in the state of the job market. The unemployment rate edged down further to 7.6% in March, in part because labor force participation continues to move lower. After popping late last year, wage growth has returned to its muted trend and over the past three months average hourly earnings in the private sector have grown at a modest 2.0% annual rate.

Tepid gains in unit labor costs have remained a persistent restraining factor for consumer price inflation. More recently, declines in energy and other commodity prices have also imparted downward pressure on the inflation data. Over the past twelve months, the personal consumption expenditure (PCE) price deflator has increased a modest 1.0%. The ex-food and energy core PCE index has also exhibited soft gains, rising only 1.1% in the year ended in March.

With inflation running significantly below the Fed's 2% inflation goal, and unemployment apparently well above levels consistent with full employment, the Fed has continued to provide monetary accommodation. Expectations for tapering off of the Fed's outcome-based purchases have been pushed back due to recent softening in the economic data. Market participants generally anticipate little change to Fed policy in coming months.

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 had a lengthy discussion regarding potential reduction in coupon issuance, in the context of the expected pay down in marketable debt in the April to June 2013 quarter. The Committee unanimously decided that it was premature to make any changes. The Committee decided to address this question further in the coming quarters when marketable borrowing needs become more clear.

The Committee then reviewed the coming announcement of the floating rate note program, spending some time on the final details of the FRN term sheet. Although the Committee had historically been split on the choice of reference index, it unanimously supported referencing the 13-week T-bill. Although this choice of index does not diversify the Treasury's funding cost, the uncertainty around other indices make the 13-week T-bill the best choice at this time.

The Committee felt that starting the program with FRNs of two year maturity was appropriate and could be expanded to other maturities as the market developed. There was also consensus on issuance sizes of $10 to $15 billion per month, with one new issue and two re-openings per quarter. Members reiterated their view that FRN issuance should replace T-bill issuance overtime, thus continuing to extend the average maturity of the debt without exposing Treasury to incremental interest rate risk.

The second charge was to address the potential impact of the Federal Reserve's exit strategy on Treasury Financing. The presentation, [attached], highlights that market forwards imply an even more benign path of tightening relative to private sector and Fed forecasts. Should the Fed embark on policy tightening, yields could overshoot to the high side due to concerns of Fed portfolio unwind and fixed income investor redemptions. Should this occur, the higher cost of financing is material as annual interest expense could more than quadruple when yields "normalize." Therefore, continuing to extend the weighted average maturity of Treasury debt in a stable manner so as to minimize term premium is sensible policy to adhere to.

The third charge was to investigate the availability of High Quality Collateral (HQC) in the financial system. The presentation, [attached], examines the potential impact of policy, both market and regulatory, on HQC supply-demand dynamics. After defining HQC as cash, or as fungible stock that can be used to secure cash at a minimal haircut, the presentation points to increased demand for HQC due to financial market participants' mandated liquidity coverage needs as well as derivatives clearing and bilateral margin requirements. These needs could push the demand for HQC to anywhere from $2.6 trillion to $5.7 trillion USD by 2020. This could be met with a corresponding growth in supply via sovereign issuance. However, a better macroeconomic climate will allow for that supply to come through private sector driven collateral transformation.

In the final charge, the Committee considered the composition of marketable financing for the remainder of the April 2013 to June 2013 quarter and the July 2013 to September 2013 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 Q2 2013 and TBAC Recommended Financing Table Q3 2013