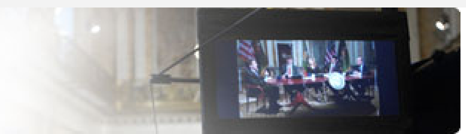
U.S. DEPARTMENT OF THE TREASURY

## Press Center



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

7/31/2013
July 30, 2013

Dear Mr. Secretary:

Since the Committee last met in late April the pace of economic growth has apparently decelerated, as spending data suggest real GDP expanded in the second quarter at a somewhat slower pace than the 1.8% annual rate experienced in the first quarter. Some of that slowing may reflect the impact of fiscal drags that are posing headwinds to the expansion. In particular, the pace of consumer spending has been subdued, likely due to the restraint of higher payroll and income taxes. In spite of the slow pace of economic growth, employment has continued to expand briskly, with payroll growth last quarter averaging close to 200,000 jobs per month. Recent Fed communications have indicated that the resilience of the labor market will most likely prompt a moderation in the pace of asset purchases sometime later this year. The market reaction to this development has been acute, as medium- and longer-term interest rates have moved sharply higher. Thus far, interest-sensitive sectors of the economy – most notably housing – have shown limited signs of slowing in response, though some delayed response to the tightening in financial conditions may be yet to come. Even so, most forecasters anticipate somewhat faster economic growth in the second half of the year relative to the first half.

Consumer spending expanded at a 2.6% rate in the first quarter but appears set to step down to about half that pace in the second quarter, a deceleration that is a result of several factors. First, spending on utilities slipped back after being boosted by unseasonably cold weather in the first quarter. Second, the increase in tax burdens at the beginning of the year is likely still having a depressing effect on consumer outlays. Lastly, rising energy prices toward the end of the second quarter also depressed real consumer purchasing power. Looking ahead, steady gains in labor income, as well as ongoing support to household balance sheets from a recovering housing market, should sustain better gains in real consumption outcomes.

After slowing in the first quarter, investment spending by businesses has exhibited signs of healthier growth in the second quarter. Most of the re-acceleration reflects a rebound in business outlays for structures, a category which suffered a temporary pull-back in the first quarter. Corporate profits may have had another poor quarter, as the combination of soft nominal GDP growth and solid increases in the total business wage bill may have depressed profit margins. Even so, capital spending is generally expected to increase in the second half as most business surveys point to solid spending intentions.

The housing market remains a bright spot for the economy, as residential investment continues to contribute to overall GDP growth. Since the Committee last met, primary 30-year fixed mortgage rates have increased almost 100 basis points. Most data points related to housing demand have held in well, though it is still too soon to judge how much the increase in rates will restrain home sales. House prices continue to register solid gains in most parts of the country.

The government sector was a significant restraint on growth in the first half of the year. The drag from state and local governments appears to be moderating, but declines in federal spending have intensified. Real federal outlays declined at an 8.7% pace in the first quarter and likely declined again in the second quarter, partly due to the implementation of sequestration, as stipulated by the Budget Control Act. While the timing of the full impact of sequestration is difficult to gauge, there are likely to be additional declines in federal spending in the second half of the year.

After declining in the prior two quarters, real exports have increased in April and May. However, real import growth has been robust, and net exports likely subtracted from overall GDP growth last quarter. Foreign economic growth remains subdued. The Japanese economy has responded favorably to recent growth initiatives, and there are some indications the European economies may be close to stabilizing. However, Chinese data remains disappointing and prospects for other large emerging market economies have downshifted since the last meeting.

Labor market conditions have shown further signs of improvement, as job growth in the first half of the year has been solid and steady. The contrast between a firm labor market and disappointing GDP is stark, and the manner in which this disparity is resolved is a preeminent question for the second half outlook. Since the Committee last met, the unemployment rate has been unchanged at 7.6%. However, this has come alongside two months of rising labor force participation—a hopeful, albeit tentative, sign that labor supply could modestly accelerate. Wage gains remain subdued, with most measures increasing around, or a little less than, 2% on a year-ago basis.

Restrained wage gains have contributed to a soft inflation environment. The PCE price deflator has increased 1.0% in the twelve months ending in May; the ex-food and energy core PCE measure has increased 1.1% over that same period. Tame domestic price pressures have been joined recently by falling import prices, thus creating a very weak pricing environment. In spite of very low inflation readings, most survey measures of inflation expectations have remained stable.

Since the Committee last met, Fed communications have led to a material shift in market expectations regarding monetary policy. At the most recent FOMC meeting in June, Chairman Bernanke indicated that the pace of asset purchases would likely be moderated later this year, a message that was hinted at in the Chairman's earlier testimony before Congress on May 22nd. The resulting increase in longer-term interest rates was greater than could be explained by standard estimates of the effect of asset purchases on yields. A change in expectations regarding future overnight interest rate policy, as well as an unwinding of levered positions, may have also contributed to the increase in interest rates seen since early May. Most surveys of market participants indicate that a moderation in the pace of asset purchases is expected at the September FOMC meeting.

Against this economic backdrop, the Committee's first charge was to examine whether adjustments to the debt issuance schedule were warranted in light of the Treasury's reduced financing needs. In particular, the Committee discussed reducing coupon issuance given the recent pay down in marketable debt over the April to June 2013 quarter as well as the potential for a surplus in financing over the coming two fiscal years if the Treasury continued on the current coupon financing schedule. Given the Committee's long established goal to increase the weighted-average maturity of the debt, moderate reductions to the coupon schedule in 2 and 3 year maturities were recommended. The Committee emphasized the importance of making gradual and modest adjustments to the issuance schedule in order to maintain future financing flexibility in light of the uncertainty regarding economic growth, budget related matters and the trajectory of future tax receipts. The Committee also considered making adjustments via reductions in US Treasury bill issuance but ultimately decided against this recommendation. Discussions centered around the reduction to Treasury bill issuance in the April to June 2013 quarter and the importance of safeguarding the liquidity and depth of the Treasury bill market given growing structural demand for high quality, short term securities. The Committee also noted the upcoming inaugural 2 year maturity Floating Rate Note issuance in January 2014 would be a replacement for Treasury bill issuance.

Next the Committee considered the concept of engaging members of the academic community to assist in projects that require longer-term analysis. Members of the Committee will make a recommendation for the potential format and structure of these types of engagements at the November 2013 meeting.

The second charge was to evaluate the liquidity of fixed income markets, both currently and prospectively, given changes to market regulations, market structure and technological capabilities. The presenting members concluded that while volumes and turnover have increased, market depth had been reduced, especially in times of elevated market volatility. The discussion highlighted some of the regulatory factors that contributed to declines in dealer balance sheet capacity, in their roles as intermediaries between buyers and sellers of fixed income securities. The Committee also considered the recently proposed supplementary leverage ratio. It was broadly agreed that this rule could have negative consequences for the Treasury repo market and Treasury's cost of financing. Technological advances and shifts in market structure have added to the appearance of liquidity as volumes and turnover levels have increased, but have not added to the depth of the markets as measured by occasional increases in bid-offer spreads and decreasing average sizes of block trades. In addition, the presenting members highlighted the potential for a significant dislocation in the markets if investor flows into riskier fixed income securities were to reverse.

The third charge was a comprehensive review of additional debt management tools and processes that Treasury could consider to minimize borrowing costs, better manage its liability profile, enhance market liquidity and expand the investor base for Treasury securities. A similar charge had been discussed in February 2011 with a comprehensive review of additional types of debt instruments and maturities, ultimately resulting in a recommendation to introduce a Floating Rate Note program. It was generally viewed that additional products should not be considered at this time until this program is well established.

The discussion covered a wide range of alternative primary market issuance techniques including multiple-price auctions, syndications, reverse inquiries and window-driven issuance. Taps, mini-tenders and over-allotment options were also considered. The discussion included an assessment of the benefits and important considerations of each technique. Next, various secondary market-techniques were discussed including repurchases, buybacks, switches, and securities lending and collateral swap facilities. The conclusion, after a lengthy discussion, was that it is important that the Treasury continues as a "regular and predictable" borrower in its debt management procedures and that the benefits do not outweigh the costs of alternative techniques or new products at this time.

In the final charge, the Committee considered the composition of marketable financing for the remainder of July to September 2013 quarter and the October to December 2013 quarter. The Committee's recommendations are attached.

Respectfully,

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Dana M. Emery
Chairman

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Curtis Y. Arledge
Vice Chairman

TBAC Recommended Financing Table Q3 2013 and TBAC Recommended Financing Table Q4 2013