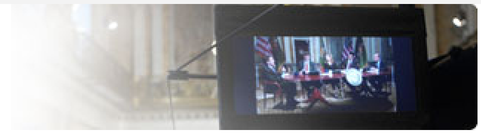
U.S. DEPARTMENT OF THE TREASURY

Press Center



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

11/6/2013
November 2013 Letter to the Secretary

Dear Mr. Secretary:

Since the Committee last met in late July the economy has continued to expand at a moderate pace. The October government shutdown not only restrained the growth of economic activity, but has also made it more difficult to assess the state of the business cycle, as a number of economic data releases have been delayed due to the temporary shuttering of federal statistical agencies. With this caveat in mind, it appears that real GDP growth in the third quarter was not materially different from the 1.8% annual pace registered in the first half of the year. Activity growth in the labor market has downshifted in recent months, and the housing market has shown signs of cooling. However, the Federal Reserve has been more accommodative than market expectations, a development which has eased financial conditions. As the distorting effects of the government shutdown fade, the economy should regain firmer footing, though another round of fiscal debates in the first quarter loom as a potential downside risk to the outlook.

The pace of consumer spending growth appears to have remained subdued in the third quarter as real consumption outlays increased a tepid 0.1%, on average, in July and August, and likely registered a similar advance in September. Retail spending has been restrained by the weak pace of earnings growth, with labor income advancing at a relatively slow 3.0% annual pace last quarter. Looking forward, consumers should get some relief in the form of lower retail energy prices, though October data may show some evidence of fiscal uncertainties leading to temporarily more cautious consumer behavior.

Business investment spending continues to be a source of modest disappointment. Capital outlays for nonresidential structures have been volatile, though appear to have advanced at a healthy clip last quarter. In contrast, business equipment spending growth has been anemic all year, and the recent orders and shipments data for capital goods indicate that this trend has persisted through late in the third quarter. The fundamentals for business investment spending remain solid, as corporate profit margins are high and the cost of capital is low. Nonetheless, the unexplained weakness in capital spending this year raises some questions about the vigor of any expected pick-up in cap-ex.

Residential investment spending has continued to advance at a healthy pace, although the recent set-back in indicators of housing demand suggests the rebound in homebuilding may cool in coming months. Since the back-up in mortgage rates began in late May, several measures of home sales and home-buying attitudes have softened. In addition, while house price appreciation is generally still quite strong, there are some hints that house price growth may cool some along with housing demand. The recent easing in mortgage rates should be supportive for home sale going forward.

The federal government shutdown in October will reduce the output of government services in the fourth quarter, though this should prove to be only a temporary restraint. A second round of sequester cuts in January could prove to drag on the economy for longer. The temporary nature of the resolution of the budget and debt ceiling implies that the possibility of another shutdown poses some downside risk to the outlook. The headwinds associated with the 2013 tax hikes should fade, partially offset this fiscal drag in 2014.

Real exports declined in July and August. Nonetheless, the external growth picture generally remains healthier than it did at the beginning of the year. Europe and Japan are still expanding, while an improvement in the Chinese data has eased fears of a hard landing in that economy.

Labor market conditions have been modestly disappointing as of late. After increasing 195,000 jobs per month on average in the first half of the year, employment growth has slowed to 143,000 positions per month in the third quarter. In spite of the slowdown in the pace of job growth, the unemployment rate has continued to decline, falling from 7.6% at the end of the second quarter, to 7.2% at the end of the third quarter. Wage inflation remains absent: average hourly earnings rose at a subdued 2.0% annual rate last quarter, the same pace as in the prior quarter. Still, the labor market suggests that there is ample slack in the economy and that GDP is well below potential. The labor market participation rate is at 63.2%, a full 3 percentage points lower than the early-2007 level. While the participant rate differs by age group, the trend in the data is similar. For example, the participation rate for the 45 to 54 age group is 2 percentage points lower than the early-2007 level.

Inflation remains quiescent. The Consumer Price Index (CPI) increased at a 1.7% annualized rate over the three months ending in September, and the ex-food and energy “core” CPI rose at a 1.6% pace. The personal consumption expenditure (PCE) measure of inflation – available through August – increased 0.1% on average in July and August, and the core PCE measure was similarly subdued. There is little indication that inflation is set to accelerate any time soon.

Since the Committee last met, Fed policy – and the outlook for future Fed policy – has shifted noticeably. Contrary to market expectations, the FOMC chose not to reduce the monthly pace of asset purchases at the September policy meeting. In addition, certain Fed policymakers have downplayed their earlier indications that asset purchases likely would be concluded as the unemployment rate approached 7%. These developments led market participants to simultaneously push back the date of the first expected tapering of asset purchases as well as to push back expectations for the normalization of the federal funds rate. This change in Fed expectations has since been reinforced by somewhat disappointing data, and many now expect the first slowing in asset purchases to occur sometime in the first half of 2014.

Against this economic backdrop, the Committee’s first charge was to examine whether adjustments to the debt issuance schedule were warranted. The Committee continues to recommend a gradual lengthening of the weighted-average maturity of the debt. However, given the uncertainty surrounding the economic impact of budget negotiations, the recent government shut-down and the debt ceiling negotiations, as well as the trajectory of future tax receipts, the Committee recommended that the issuance remain at current levels and not continue with the gradual decline of 2 and 3 year maturity issuance sizes as was recommended at the July TBAC meeting. The Committee also recommended that Treasury move forward with the inaugural auction of $10 to 15 billion of 2 year maturity Floating Rate Notes, which the Committee views as a substitute for Treasury bill issuance, with the flexibility for longer maturities as the market develops.

Evolving regulation and potential market structure changes that could impact short-term funding markets were discussed by the Committee. Specifically, the calculation of the Supplementary Leverage Ratio (SLR) when this regulation is finalized could potentially unfavorably impact liquidity conditions and US Treasury issuance dynamics. The discussion highlighted that the proposed Basel leverage ratio calculation, which does not permit repo netting (as described in FIN 41), could have significant negative consequences on financing markets and overall market liquidity.

In this context, the Committee considered the composition of marketable financing for the remainder of the October to December 2013 quarter and the January to March 2014 quarter. The Committee’s recommendations are attached.

The Committee’s second charge was to discuss how technological advances have impacted the way assets are traded in the fixed income markets, with a focus on the increase of electronic trading (both High Frequency (HFT) and Algorithmic Trading (AT)), specifically in the US Treasury market. The presenting members focused on the use of electronic trading for both execution strategies and automated trading strategies. The presenting members emphasized that there is a lack of consensus regarding electronic trading protocols, methods and venues, given the wide variety of market participants such as traditional dealers, HFT firms and end users. These participants have diverse trading objectives, strategies and requirements in their use of electronic trading. Further, the adoption of electronic trading in the fixed income and foreign exchange markets has been extremely gradual, with the largest volume occurring in the most homogenous, liquid and commoditized segments of the markets, primarily on-the-run US Treasuries and spot FX. As the electronic trading volume of on-the-run Treasury securities increases, it could enhance their liquidity and reduce future Treasury borrowing costs, especially if volumes of electronically traded off-the-run securities increase over time as well. The presenting members emphasized the importance of implementing quality risk controls for firms that participate in the HFT and AT given the associated risks. They concluded that it is unlikely that a singular end state solution for fixed income electronic trading will emerge given the heterogeneous nature of the market and the diverse needs of the market participants and that asynchronous mandates for Central Clearing and electronic trading create stresses on the linkages across the rates markets (cash bonds and repo, swaps, futures and credit (cash and CDS)). Given the linkages across the rates markets, liquidity in one market can significantly impact the others; regulations and protocols for each market should be synchronized so as not to have an adverse impact on overall liquidity. Lastly they provided a listing of current industry "best practices" for automated trading.

Continuing with a topic that was initiated during the July 2013 TBAC meeting, the Committee discussed the engagement of the academic community for projects that would benefit from longer-term research and analysis. After considerable discussion, the consensus was for a subset of the TBAC, with support of the Treasury staff, to seek the engagement of academic experts to undertake a study of the optimal sovereign debt issuance strategy with a comparison to current practices, including practical suggestions for potential consideration.

Respectfully,

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Dana M. Emery

Chairman

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Curtis Arledge

Vice Chairman

TBAC Recommended Financing Table Q4 2013 and TBAC Recommended Financing Table Q! 2014