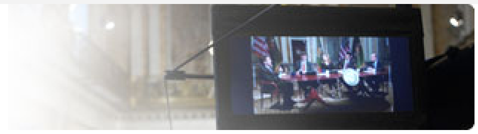
U.S. DEPARTMENT OF THE TREASURY

**Press Center**



# TBAC Report to the Secretary August 4, 2015

8/5/2015
Letter to the Secretary

Dear Mr. Secretary:

Since the Committee last met in May, economic activity has accelerated substantially. Second quarter annualized real GDP growth rebounded to 2.3% according to the advanced estimate, up from a revised and mildly positive 0.6% in the first quarter. Weakness in the first quarter has been primarily attributed to transitory factors, including adverse weather and disruptions caused by the West Coast port strike. In addition, the strengthening of the U.S. dollar affected the manufacturing sector, while the plunge in oil prices led to a sharp decline in energy investment. As the transitory factors fade, domestic demand has strengthened noticeably over the past few months. Consumer spending accelerated and net exports and state and local government spending rebounded moderately, while fixed investment stalled.

Non-national account indicators also point to a strengthening of the economic outlook. Household and business confidence measures remain near post-crisis highs, the housing market continues to strengthen, wage growth has begun showing signs of gradual acceleration, and the unemployment rate has moved closer to its natural level. These changes indicate an improved economic picture, with the pace of economic activity running clearly above potential.

The largest contributor to GDP growth during the second quarter was private consumption which grew at a real annualized growth of 2.9% and contributed 2.0 percentage points. The rebound was entirely due to consumer spending on goods. Vehicle sales picked up from an annualized sales pace of 16.6 million in the first quarter to 17.1 million in the second quarter. Disposable income increased, benefiting from lower gasoline prices, and the savings rate continued to decline, although it remains considerably above pre-crisis levels. The gradual re-leveraging of consumer balance sheets, along with strong consumer confidence, should support continued consumption growth.

The housing market has generally strengthened after a winter slowdown, but prints from various indicators remain mixed. On the positive side, existing home sales have exceeded expectations and reached a new post-crisis high at an annual rate of nearly 5.5 million units, pending home sales continued to rise, and homebuilder indices reached post-crisis highs. On the weaker side, new home sales disappointed with declines in all regions except the Northeast, and home prices---although they continue to rise---have advanced more slowly than market expectations. On net, recent trends point to further strengthening of the housing market. Household formation continues to rise, driven by renter-occupied units, and mortgage lending standards continue to ease.

Total fixed investment growth decelerated from 3.3% in real annualized terms during the first quarter to 0.8% in the second quarter. Residential investment grew 6.6% but overall business fixed investment declined. While intellectual property investment by businesses grew at a healthy pace during the quarter, it was offset by contractions in structures and equipment investment, primarily in the oil and gas sector. Although overall business fixed investment remains weak, it is expected to rebound in the second half of the year.

After a sharp decline in the first quarter of the year, net exports have rebounded more recently. The bulk of the impact from U.S. dollar appreciation was felt in the first quarter, when exports declined sharply. Since March, however, the dollar stabilized and allowed for a bounce back in annualized export growth by 5.3% in the second quarter, while imports decelerated to 3.5%. Despite that rebound, net exports are expected to decline over the next few quarters as dollar strength resumes and global demand is expected to remain weak.

Labor markets have been improving. During the second quarter, 664,000 new jobs were created, and the unemployment rate fell to 5.3%, near many estimates of the natural rate of unemployment. Still, part time and broader measures of unemployment remain elevated, and most measures of compensation growth remain little changed around 2%.

The personal consumption expenditures (PCE) price index increased at a 2.2% annual rate during the second quarter, as energy prices partially rebounded from their earlier declines. The ex-food and energy core PCE price index increased at a 1.8% annual rate last quarter, but is up only 1.3% over the prior four quarters.

FOMC statements and communications from Federal Reserve officials continue to point in an accommodative direction, but at the same time, they have kept the door open for a federal funds rate increase to take place in the second half of the year. At present, market participants remain divided in their expectations for when exactly the hike will take place, but there is broad consensus that the decision will depend on the evolution of inflation and labor market slack over the next few months.

Against this economic backdrop and as part of Treasury and TBAC's efforts to determine the optimal debt issuance strategy, the Committee's first charge was to examine the meaning of "regular and predictable" in the Treasury's stated debt issuance policy. In addition, the Committee was asked to evaluate the impact of the policy on Treasury's flexibility to adjust issuance patterns as warranted to achieve its goal of issuing at the least cost over time to the US taxpayer and maintaining a well-functioning market. Treasury has adhered to a regular and predictable issuance framework since the 1970's when the deficit began to increase significantly and research shed light on the increased costs of a more tactical approach. To be regular and predictable, Treasury standardized its communications with regard to its debt issuance schedule and expected size of auctions, typically as part of the Quarterly Refunding announcement, and provided significant lead time regarding the introduction or elimination of particular maturities or new instruments. The Committee noted that the benefits of issuing in a regular and predictable framework include a projected lower borrowing cost as the Treasury captures the associated liquidity premium. In addition, the Committee discussed the benefits of increased flexibility given the uncertain environment in which the Treasury operates, including the ability and willingness to adjust issuance patterns in response to changing deficit funding needs, the Fed's decision regarding SOMA reinvestments, market dislocations, and changes in term or inflation premiums. Offsetting these benefits are the potential costs of being more tactical if investors demand a higher risk premium due to a less predictable issuance pattern. The Committee discussed the parameters by which Treasury could adjust issuance patterns including size, frequency, maturities, and instruments. In making adjustments, Treasury should consider the impact on market function, the depth and sustainability of investor demand, and primary dealer constraints, and should take account of longer-term funding needs and projected funding costs. The Committee discussed the benefits of maintaining a full yield curve with liquid benchmark securities and emphasized the need to establish a well-planned and clear communication strategy, while avoiding a purely formulaic approach. Given the size of issuance needs, adjustments to issuance patterns should be gradual and should incorporate primary dealer feedback. Communication regarding adjustments to issuance should also be as comprehensive as possible, ideally with an explanation of the rationale and how the adjustments are in support of Treasury's debt management principles and objectives.

The Committee's second charge was to discuss the risks and benefits of increasing the proportion of longer-term debt relative to shorter-term debt in light of historically low interest rates and term premiums and whether doing so would be in keeping with Treasury's mandate to fund the government at the lowest cost over time and maintain a regular and predictable debt issuance schedule. One Committee member prepared slides showing that interest rates and term premium are near multi-decade lows and reviewed past issuance patterns that have increased the proportion of coupon debt relative to Tbills, resulting in a lengthening of the average maturity of the debt from a low of 48 months to 70 months, the highest seen since the 1950s and well above the 59 month long-term historical average. One member noted that longer maturity debt issuance is warranted when real rates are low, term and liquidity premiums are low relative to those on shorter-dated securities, correlation of interest rates with GDP growth is low or lags GDP growth and/or longer-term assets would benefit from a liability match. Simulations of adjusting debt issuance from the current pattern -which is skewed toward short to intermediate maturities- to issuance that is more evenly proportioned, shows that the cost of issuing longer-term debt is currently low but that the insurance benefits are marginal. This analysis, however, makes several important assumptions about term premiums at different maturities and that the issuance of longer-term debt does not increase funding costs. Benefits of issuing a greater proportion of longer-term debt could be a reduction in borrowing cost volatility, and better addressing the ALM mismatch with long-maturity student loan assets held by Treasury. Costs include the uncertainty of funding expense due to varying term and liquidity premiums, uncertain investor demand and the slower adjustment in interest expense to changing nominal growth rates. The member presented a simulation of short-term interest rates, noting an ability to save interest expense based on current term premiums but that the savings may not be as large as they have been historically. The Committee also discussed the current liquidity premium afforded to Tbills, given the demand for high quality liquid collateral. The Committee noted that further analysis is warranted regarding the asset liability framework and the durability of liquidity premium in the front end of the curve.

The Committee's third charge was to examine whether adjustments to the Treasury's debt issuance schedule were warranted in light of current and projected funding needs. To inform this discussion, Treasury staff provided the Committee with the attached presentation on the fiscal outlook, receipts and outlays, financing projections and auction demand. Given the projected increased funding needs in FY2016 and beyond, which could increase further were the Fed to end reinvestment of Treasury maturities, the Committee recommended that the Treasury maintain its current issuance pattern. While operational cash balances can be adjusted via Treasury bill issuance, it was noted that both bill issuance and the Treasury's operational cash balance may need to be cut dramatically over coming weeks and months if Congress does not raise the debt limit in a timely manner. As discussed in prior letters from the Committee, there is potentially significant risk associated with holding a lower operational cash balance and there are negative implications for bill market functioning associated with large issuance reductions. These risks could be exacerbated by a confluence of events related to the implications of money market reform and the stance of Federal Reserve monetary policy. The Committee also emphasized the importance of smooth market functioning to minimizing the cost of debt issuance over time and was supportive of increasing the stock to Tbills outstanding to aid the proper functioning of the short-term debt markets given the increasing demand for high-quality liquid collateral in light of regulatory changes. The percentage of Tbills outstanding is at a multi-decade low of approximately 11%, with an outstanding stock of $1.4 trillion. In addition, given the low level of rates and term premium, the Committee was supportive of issuing coupon debt in similar proportions to recent auctions to allow for a laddered debt maturity profile and a gradual lengthening of the average maturity of the debt outstanding. Nevertheless, the Committee strongly encouraged Treasury to continue to conduct rigorous cost/benefit analysis to determine its optimal debt issuance strategy based on the principles and objectives of debt management and to communicate future issuance choices within the context of those objectives.

Respectfully,

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Dana M. Emery
Chairman

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Curtis Y. Arledge

Vice Chairman

August 2015 TBAC Recommended Financing Table Q3 2015 and August 2015 TBAC Recommended Financing Table Q4 2015