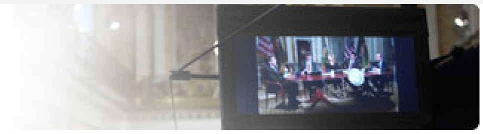
U.S. DEPARTMENT OF THE TREASURY

Press Center



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

11/4/2015

November 3, 2015

Letter to the Secretary

Dear Mr. Secretary:

Since the Committee last met in early August, the economy has continued to expand at a moderate pace. Although the real GDP growth rate slowed from 3.9% in the second quarter to 1.5% in the third quarter, most of that decrease was due to a transitory downshift of inventory accumulation. Final demand expanded at a more-robust 3.0% rate, underpinned by continued solid growth in consumer spending. The pace of hiring slowed in August and September, particularly among export-oriented industries. Following a period of heightened volatility beginning in mid-August---due to concerns around growth in China, the devaluation of the renminbi, and broader stress in emerging economies---financial markets have rebounded of late. Fiscal policy has gained some certainty, as Congress recently reached a two-year budget deal and suspended the debt ceiling through March 2017. In its October statement, the Federal Reserve signaled that it is considering raising interest rates in December, should economic data over the next few weeks suggest the outlook is conducive to the attainment of its targets.

Consumer spending has been the locomotive for the economy in recent quarters, supported by an acceleration of disposable personal income aided in large part by falling gasoline prices. Real consumption increased 3.2% in the third quarter and has increased at over a 3% annual rate in five out of the last six quarters. Even so, over the past five quarters the savings rate has remained above 4.6% and even increased a touch above that during the third quarter. A notable area of strong consumer spending growth has been in health care, which has seen a 4.7% increase in real outlays over the past year. Consumer confidence remains close to post-crisis highs.

Business fixed investment spending increased at a modest 2.1% annualized rate last quarter; outside of the energy sector, investment outlays grew at a more respectable 5.1% rate. Weekly data on oil rigs indicate the oil and gas industry will present less of a drag on overall capital spending growth in the current quarter. Business inventory investment was unsustainably robust in the first half of the year, as firms found themselves overstocked after disappointing demand growth in the first quarter. The deceleration in inventory accumulation last quarter subtracted 1.4 percentage points from GDP growth. It appears that this realignment of production and demand is nearing completion, and manufacturing surveys have recently shown some green shoots after a slow start to the year. Overall, business fixed investment is expected to remain strong over the next few quarters.

Housing indicators have generally been strengthening. Most house price measures show steady growth at around a 5% annual rate and continue to reach post-crisis highs. In addition, the most recent homebuilders sentiment index stands at a 10-year high. Housing starts have increased substantially, driven by multi-family construction growth, while single-family construction growth is positive but moderating. Rising household formations and strong affordability measures are expected to support future growth. The forward-looking pending home sales index, however, has indicated some moderation in housing demand.

Real government spending expanded at a 1.7% annualized rate during the third quarter, primarily due to state and local government spending, and contrasting with the contraction that prevailed from 2010 to 2014. Looking ahead, Congress and the White House recently agreed to a budget that modestly increases federal spending over the next two years. Equally important, the debt ceiling was suspended through March 2017, removing a source of uncertainty lingering over the outlook.

After a large drag in the first quarter, foreign trade has been basically neutral for growth in the second and third quarters. While concerns about Chinese growth continue to cloud the global outlook, export and industrial production data from several other Asian emerging market economies suggest a turn in the technology product cycle is supporting somewhat firmer global growth. In trade-weighted terms, the dollar has been relatively stable over the past three months, providing some respite for US manufacturers.

After averaging 245,000 job gains per month over the prior twelve months, employers increased headcount by only 139,000 per month, on average, in August and September. Much of the slowing occurred in manufacturing and other export-oriented industries. Even with the downshift in job creation, labor market slack continues to narrow, as the unemployment rate fell from 5.3% in July to 5.1% in September. Compensation growth remains subdued; the Employment Cost Index rose 2.0% in the year ending in the third quarter, and most other wage measures show a similarly tepid pace of gains.

With moderate wage gains and import prices continuing to decline, underlying inflation pressures remain muted. Headline inflation measures were depressed by a renewed decline in energy prices. The ex-food and energy core personal consumption expenditure (PCE) deflator rose 1.3% during the year ending in September, consistent with the year-over-year growth rates of the past several months. A waning of the transitory restraints of lower energy and import prices should put some upward pressure on core inflation in coming months. However, inflation expectations – based on market and survey measures – remain low.

After sending a very dovish message at the September FOMC meeting, the FOMC turned more hawkish in its October statement. The Committee dropped the reference to global economic and financial developments restraining domestic growth and inflation. Moreover, the statement indicated that the FOMC will consider a target federal funds rate rise at its next meeting in December, should economic conditions continue to move in the direction of the Fed's labor and inflation targets. After the statement, the federal funds' futures markets priced in an increased probability of a December rate increase, though incoming data will figure prominently in shifting market expectations.

Against this economic backdrop, the Committee's first charge was to review Treasury's November 2015 Quarterly Refunding Presentation to the TBAC. As indicated in the attached presentation, Treasury, due to the debt ceiling, is currently operating below the recommended $150 billion minimum daily cash balance that was established in May 2015. Treasury plans to increase Tbill issuance significantly, by increasing the size of the 4-week, 3-month and 6-month auctions and through cash management bill issuance. Based on the current auction schedule, Treasury is projected to increase new bill issuance by $186 billion by the end of December 2015 and to increase its forecasted end-of-quarter cash balance to $344 billion. Given the high demand for Tbills due to money market reform and regulatory changes, the Committee believes increased Tbill issuance will both enhance market functioning and help the Treasury achieve low cost funding.

In addition, the Committee discussed Treasury's 2016 financing projections. Assuming the Federal Reserve reinvests its SOMA portfolio, Treasury will be underfunded by $68 billion if it maintains its current auction schedule. The Committee discussed the benefits of increased Tbill issuance to enhance short-term market functioning, recommending an increase above the projected shortfall. Therefore, the Committee recommended that the Treasury consider a moderate reduction in coupon issuance in coming quarters, assuming revenues and outlays remain as projected.

As a follow-up to the Committee's May request and in light of the expected shift of assets from prime to Treasury money market funds, Treasury provided an initial assessment of potential introduction of 2- month bills to distribute Tbill issuance across more maturities and to address increased projected demand for Tbills due to market structure changes and money market reform. Treasury staff asked for the Committee's feedback regarding settlements, operational considerations, issuance frequency, size, and maturity cycle. The Committee agreed that the 2-month Tbill was worth exploring further, particularly with money market fund managers. One member noted that money market demand has displayed seasonal patterns and that demand may be more centered in maturities of one month and shorter. The Committee recommended that Treasury also consider the potential benefit of 2-week Tbills.

The Committee's next charge was to consider the practicality and potential considerations of applying an asset-liability management framework ("ALM") to Treasury's debt issuance strategy. If deemed practical, the Committee was tasked to consider approaches to minimize cost and optimize net new issuance to finance various assets, including student loans. ALM is the practice of managing an organization such that decisions with respect to assets and liabilities are coordinated in an effort to achieve its financial objectives within its given risk tolerance. The US sovereign presents a unique set of ALM modeling challenges given the complexity of balance sheet components and the interconnection but independence of fiscal, monetary and debt management functions. One member noted that a large-scale application of ALM would require some agreement on the importance of mitigating roll-over risk. One member suggested that one set of assets that may be appropriate for an ALM debt issuance framework is Treasury's $1.2 trillion student loan portfolio. However, given the inherent cash flow uncertainty, future policy risk, and the relatively small size of the student loan debt, the Committee recommended that Treasury continue to monitor this portfolio, rather than employ a specific asset-liability framework to one set of assets.

Respectfully,

____

Dana M. Emery
Chairman

____

Curtis Y. Arledge
Vice Chairman
TBAC Recommended Financing Table Q4 2015 and TBAC Recommended Financing Table Q1 2016