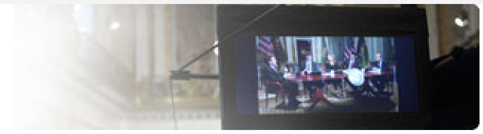
U.S. DEPARTMENT OF THE TREASURY

Press Center



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

5/6/2015
May 5, 2015

Letter to the Secretary

Dear Mr. Secretary:

Since the Committee last met in early February, U.S. economic growth has slowed noticeably. Real GDP growth in the fourth quarter of 2014 was revised downward to 2.2% in annualized terms, while growth in the first quarter of 2015 declined to a meager 0.2%. Various factors lie behind this deceleration, some of which are expected to be temporary, including unseasonably harsh winter weather, a sharp contraction in oil drilling activity, and strikes that snarled operations at West Coast ports. Consumer spending slowed meaningfully, even as disposable income strengthened. Fixed investment declined, affected by a sharp contraction in nonresidential investment, while residential investment decelerated. Net exports contributed negatively to growth, but this was partially offset by rising inventory accumulation. Contrary to what these national account measures reflect, survey measures of activity remained firm, with confidence measures reaching pre-crisis highs. In turn, job gains remained solid, despite a large disappointment in the March report. Even so, economic activity is generally expected to accelerate in the second quarter to a pace at or above trend growth; sentiment measures remain elevated and financial conditions are broadly accommodative. Early April activity data such as monthly auto sales and weekly jobless claims are consistent with this benign outlook.

These growth dynamics were a result of both domestic and global factors. As in the first quarter of last year, part of the weakness in activity can be attributed to harsh winter conditions. In turn, the impact from declining oil prices led to a sizeable increase in disposable income, but the stabilization and even slight increase of oil prices during the quarter may have curtailed households' propensity to spend. The decline in oil prices also led to sharp cuts in drilling activity and energy investment. Equity markets rose to historic highs, while long-term yields oscillated during the quarter, as markets took signs from policy statements by the Federal Reserve and the expansion of the ECB's asset purchase program. The upward trend in the dollar continued, affecting net exports and certain corporate earnings.

Within the main contributors to GDP growth, real consumer spending slowed noticeably, from an annualized rate of 4.4% in the fourth quarter of 2014, to 1.9% in the first quarter of 2015. This contrasted with growth in real disposable income, which accelerated from 3.6% to 6.2% over the same period. As a result, the personal saving rate increased to 5.5% of disposable income, as households scaled back from spending the windfall from the earlier decline in energy prices. Unusually severe weather in the Northeast may have also curtailed spending. However, consumer confidence rose to historic highs during the quarter, buoyed by gains in the labor market.

Total fixed investment contracted sharply, from a positive growth rate of 4.5% in the 4th quarter 2014 to a negative 2.5% in the first quarter. The contraction came from the nonresidential side, with a sharp fall in its structures component and almost zero growth in its equipment component. Spending cuts in oil exploration and drilling subtracted 0.5 percentage points from GDP growth. As anticipated early this year, capital spending in the oil and gas sectors was poised to adjust downward in the face of lower energy prices. It is therefore no surprise that the energy sector has become a major drag. As this adjustment unfolds, it is likely that business fixed investment remains subdued, even as residential investment picks up.

The housing market is still showing mixed signals. Growth in residential fixed investment slowed from 3.8% in the previous quarter to 1.3% in the first quarter. Housing starts decelerated from last year's peak at 1.06 million to about 0.97 million in the first quarter. Sales of new single-family homes reached a post-crisis peak during the quarter, but sales of existing homes stalled. Household formation also decelerated from its recent peak of 2.0 million late last year to 1.5 million in March. Home price indicators continued to strengthen, at least through the beginning of the quarter. Although mortgage spreads are tight, they are expected to tighten moderately further in the next few quarters. As credit standards remain tight, residential activity is not expected to pick up meaningfully in the near term.

On the side of government spending, federal outlays expanded by 0.3%—a moderate expansion but considerably higher than the 7.3% contraction in the previous quarter. However, state and local government spending contracted by 1.5% in the first quarter. Still, the government sector continues to exhibit steady and positive growth rates on a year-to-year basis, with the state and local category having now accelerated for eight consecutive quarters.

From the external accounts perspective, exports declined sharply—by 7.2% in annualized terms during the first quarter, compared to a positive increase by 4.5% in the previous quarter. In turn, imports decelerated to 1.8% from 10.4% over the same period. In seasonally-adjusted dollar terms, net exports reached –$538bn in the first quarter, compared to –$549bn in the previous quarter. These figures may have been partly distorted by strikes at West Coast ports. More importantly, these dynamics have and will continue to reflect the evolution of the trade-weighted dollar—whose strengthening has recently moderated but could resume over the next few quarters as growth, inflation and interest rate differentials favor the U.S. In addition, other advanced economies are facing idiosyncratic challenges, like the Greek debt situation in the Euro area, the continuation of Abenomics in Japan, and the electoral process in the U.K.

The labor market continued to make gains during the first quarter, with the unemployment rate declining to 5.5% in March, and the participation rate remaining stable at around 62.8% for the quarter. Non-farm payrolls disappointed in March, but the seasonally-adjusted change still averaged 197 thousand per month over the first quarter. The employment cost index rose by 0.7% during the quarter, reflecting similar increases in its wages and salaries component and its benefits component. Overall, wages continue to grow slowly, but increases in low-end wages by a few large corporations and broader labor market gains should provide some support overt the coming months.

On the inflation front, prices weakened even further during the first quarter. Headline personal consumption expenditure (PCE) inflation declined to 0.3% year-over-year, considerably lower than the previous quarter's 1.1% and the lowest level since 2009. But the decline was mostly due to the fall in energy prices, as the core measure—which excludes food and energy components—declined only slightly, to 1.3% compared to 1.4% in the previous quarter. Going forward, the narrowing of economic slack and the eventual fading of the impact from lower energy prices are likely to put upward pressure on prices, even as a resumption of the strengthening of the dollar would point in the opposite direction.

Since the Committee last met in early February, there have been two FOMC meetings. The March meeting confirmed a relatively dovish stance. Although the FOMC removed the "patient" element in its forward guidance, it stated that it would hike interest rates "when it has seen further improvement in the labor market and is reasonably confident that inflation will move back to its 2 percent objective over the medium term." In addition, the median projections for the federal funds rate fell 50bp to 0.625% at end-2015, consistent with two rather than three 25bp hikes occurring in 2015. The statement from the April meeting did not include any meaningful policy changes. Instead, attention centered on its acknowledgment that economic growth had decelerated, partly reflecting what the Committee characterized as "transitory factors."

Against this economic backdrop, the Committee's first charge was to clarify and reaffirm the Treasury's multiple objectives and to discuss the general framework used to determine the Treasury's optimal debt issuance strategy over time. To aid in this discussion, Treasury staff presented the attached report entitled "Treasury Debt Management Strategy" to the Committee. Since 2009, given the historically low level of rates and significant debt financing needs, Treasury issued a larger proportion of longer maturity debt and extended the weighted-average maturity (WAM) of the debt from 48 months to 69 months. However, optimal debt management includes a range of priorities that go beyond a simple WAM measure. Indeed, as the TBAC discussed at its February meeting, WAM is too blunt a metric to be used alone. Other priorities for debt issuance include funding at the least expected cost to the taxpayer over time, supporting smooth market functioning, minimizing exposure to shifts in interest expense, providing a risk-free benchmark rate across a full range of maturities and lowering rollover risk by issuing longer term debt. In addition, given the significant amount of debt that must be issued to finance the deficit and to roll maturing debt, the Committee reaffirmed the need to be regular and predictable in debt issuance and to make gradual changes to debt issuance patterns as warranted by the above stated objectives.

A March survey of primary dealers regarding their assessment of how quickly, and to what degree, the Treasury could adjust auction sizes without incurring significant pricing concessions indicated that there is room to adjust auction sizes gradually and still maintain market liquidity. Please see the below link to the dealer survey on the Treasury website. In addition, the Committee affirmed that smooth market functioning is crucial to minimizing the cost of debt issuance over time. To that end, the Committee discussed the merits of increasing the amount of Treasury bills (Tbills) outstanding to aid the proper functioning of the short-term debt markets given increasing demand for high-quality liquid collateral. One member indicated that the interest rate risk associated with increased issuance may theoretically be hedged given higher short-term rates are generally associated with stronger economic results and improved tax receipts. The Committee recommended that Treasury increase the stock of outstanding Tbills in order to support market function and to raise the operational cash balance. As such, this change should not be viewed as a change in the Committee's recommendation to continue to issue longer-term debt. The Committee encouraged Treasury staff to conduct further detailed analysis of the expected cost of issuance across a range of maturities and report back at a future meeting. The Committee strongly agreed that ongoing cost/benefit analysis in the construct of an analytical framework should continue to be an important factor in determining the optimal debt issuance strategy.

The Committee's next charge was to discuss the appropriate amount of Tbills outstanding, both in terms of the absolute amount and as a percentage of outstanding debt, in relation to the potential demand for high quality, short-dated securities. Tbill supply as a percentage of the total Treasury debt outstanding is currently about 11 percent, a multi-decade low. At the same time, with $1.4 trillion in Treasury bills outstanding, the total volume of Tbills remains near historically high levels. The Committee discussed the drivers of potential demand for high quality, short-dated securities and, given these and other considerations, whether Treasury should adjust Tbill issuance in the coming year. Current developments in market structure, regulations, and policy have the potential to change significantly the supply and demand in the market for short-end, high-quality assets. US Treasury bills are centric to the ecosystem as they are the closest substitute to cash given their strong liquidity, lack of credit risk and minimal duration risk. While the availability of short-end, high-quality asset supply has stayed stable since 2012, US Treasury bills outstanding have decreased by 25% from the 2009 peak. At the same time, Treasury bill demand has been increasing and is projected to continue to increase further, potentially significantly in a stressed scenario. Key drivers of demand include changes to bank capital rules including the liquidity coverage ratio and the net stable funding ratio, more favorable treatment of Tbills under Dodd-Frank for margin collateral posting, and money fund 2a-7 reform which may drive demand from prime funds to government funds. The Committee also discussed other considerations such as uncertainty about the size and availability of the Federal Reserve's reverse repurchase agreement facility. After considerable discussion, the Committee recommended that the Treasury increase the level of Tbills outstanding over the coming year through an increase in the size of one- and three-month bill auctions but should also maintain its current pattern of coupon issuance. The Committee also recommended that the Treasury study the introduction of regular two-month auctions. This strategy would boost the amount of structural cash, thereby providing for smooth market function in normal and stressed environments.

Http://www.treasury.gov/resource-center/data-chart-center/quarterly-refunding/Pages/dealer-agenda-survey.aspx

Respectfully,

____

Dana M. Emery
Chairman

____

Curtis Y. Arledge
Vice Chairman

TBAC Recommended Financing Table Q2 2015 and TBAC Recommended Financing Table Q3 2015