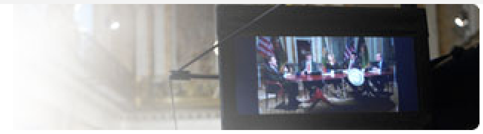
U.S. DEPARTMENT OF THE TREASURY

## Press Center



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

2/4/2015
February 3, 2015

Letter to the Secretary

Dear Mr. Secretary:

Since the Committee last met in early November, the economy has continued to expand at a solid pace. Real GDP growth in the third quarter of last year was revised up to a 5.0% annualized pace, and the economy expanded at a slower, but still above-trend, 2.6% pace in the fourth quarter. A steep decline in energy prices boosted household purchasing power, contributing to fourth quarter consumer spending growth at the fastest pace since 2006. A noticeable improvement in consumer sentiment augurs well for further gains in household outlays. The global economy continues to loom large for the domestic economic outlook. Global growth concerns relative to the dynamism of the US economy, and the corresponding divergence of monetary policy biases, have supported a strengthening of the US dollar with respect to most other currencies. In a context of still largely accommodative monetary policy by the Federal Reserve, these factors have put downward pressure on US interest rates, especially on the long-end of the yield curve. The strong dollar poses a headwind for domestic manufacturers and other exporters, although most forecasters expect strong consumer spending and generally accommodative financial conditions to support continued above-trend growth in 2015.

Real consumer spending advanced at a very strong 4.3% pace last quarter, following an upwardly-revised 3.2% rate in the third quarter. The decline in retail gasoline prices has freed up considerable funds for spending on non-energy goods and services, and this factor should remain supportive of consumption in the first quarter as well. The rise in consumer sentiment gauges is likely influenced by this decline in gas prices, while consumer attitudes toward the health of the labor market and prospects for labor income growth have also turned up recently as well.

After expanding solidly in the middle two quarters of the year, real business fixed investment spending growth cooled to a 1.9% pace in the fourth quarter. Capital equipment outlays contracted modestly last quarter, while business spending on intellectual property products remained robust, expanding at a 7.2% pace. Looking ahead, capital spending in the oil and gas sector is a natural source of concern, and anecdotes as well as weekly data on oil rigs indicate an adjustment is already underway. Away from the oil and gas sector, the capital spending fundamentals appear consistent with continued moderate growth in business investment spending.

Housing market conditions remain mixed. Residential investment rose at a moderate pace of 4.1% in the fourth quarter, albeit somewhat faster than in the third quarter. The most recent data on new and pending home sales have sent conflicting messages on the state of housing demand. Household formation increased by over 1.6 million in the fourth quarter, primarily among renter households. However, the surge in renter households pushed down the homeownership rate to 64%, the lowest level since 1994. The slowdown in first-time home buyers continues to depress residential investment. At the same time, the decline in mortgage rates should provide some support in the near term. Home price changes have been sending a relatively more consistent message, with most measures indicating growth in the mid-single digits.

Real government spending contracted at a 2.2% pace last quarter, a decline that was entirely due to a decline in defense spending that retraced an upward spike in the prior quarter. Away from defense spending, the government sector has been exhibiting steadier and more-favorable growth trends in recent quarters.  In particular, year-on-year growth in spending has now been positive for seven consecutive quarters in the state and local sector.

Net exports subtracted a sizable 1.0 percentage point from growth last quarter, mostly due to a strong 8.9% growth in imports and a deceleration in export growth.  Import growth may have contributed to the large inventory increase last quarter, which added 0.8 percentage point to GDP growth. Looking ahead, decelerating inventory accumulation should subtract from growth, but the impact on the domestic economy may be buffered by a concomitant slowing in import growth.

Labor market activity has remained strong. Net employment creation exceeded 2.9 million jobs last year, and monthly job growth averaged 289,000 in the fourth quarter. The unemployment rate declined further to 5.6% in December, falling 1.1 percentage points over the course of 2014. Wage measures have sent conflicting signals recently. Average hourly earnings posted a rare decline in December, while the Employment Cost Index accelerated in the last three quarters of the year. Over 2014, wages and salaries expanded by a 2.1%, firming from a previously weaker pace.

Consumer price inflation continues to run very weak, held down noticeably by declining energy prices. Headline personal consumption expenditure (PCE) inflation declined to 1.2% year-over-year in November. In turn, the ex-food and energy core PCE measure advanced at a modest 1.4% year-over-year rate in November. Looking ahead, some pass-through from lower energy prices and a stronger dollar should limit core inflation increases in the near term, before gradually giving way to upward pressure from narrowing economic slack.

In recent statements, the FOMC has indicated that it can be patient before raising the federal funds rate. After its late –January meeting, the FOMC upgraded its assessment of domestic economic conditions, but also noted that international developments will be factored in when considering the date of the first interest rate increase. In public speeches, some FOMC members have signaled that mid-year 2015 could be a reasonable time for such a move, should growth and inflation dynamics evolve favorably over the coming months. But a large degree of uncertainty remains on this front, while commentators and market pricing increasingly point toward a later date.

Against this improved economic backdrop, the Committee's first 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. Assuming the improved fiscal outlook as projected in CBO forecasts, the Treasury would be slightly overfunded in FY 2015 if auction sizes were to remain at constant levels. However, funding requirements are projected to increase again in FY2016. Another complicating factor is the debt ceiling requirement. On March 15, the debt ceiling will automatically be increased to include the amount of borrowing that occurred during the suspension period (February 8, 2014 to March 15, 2015) but Treasury is expected to reduce its the cash balance essentially to the level it was on February 8, 2014, approximately $30 billion. Cash at the beginning of January 2015 was over $200 billion but will naturally decline due to the tax refund season. As the March 15 date approaches, the Committee recommends that the Treasury absorb excess cash above the required amount through reduced Treasury bill issuance. The Committee also considered further reductions of 2- and 3-year note auction sizes to address the projected overfunding in FY2015 but ultimately recommended that Nominal Coupon, TIPS and FRN auction sizes remain at current levels in anticipation of increased funding needs in FY2016. The Committee reiterated its recommendation that the Treasury increase its structural cash, on the order of $500 billion, to ensure that Treasury obligations could be met were the Treasury to lose market access for operational reasons.

The Committee's second charge was to examine the use of the weighted-average maturity (WAM) of the outstanding Treasury debt portfolio as a simple proxy for its structure, cost, and risk.  Since the 2008/09 financial crisis, Treasury has extended the WAM from 49 months to 68 months, and the WAM is now approaching a multi-decade high. Treasury asked for the Committee's views on the use of

WAM as a metric for measuring the debt portfolio and whether Treasury should monitor and publish other metrics with respect to the portfolio. The Committee noted that the positives of the use of WAM were that it is a simple summary indicator and is very easy to communicate publically. The challenges of this weighted-average measure is that it may overstate or understate refinancing risk, it does not adequately capture the distribution of outstanding debt, it does not sufficiently capture the ex-ante cost of issuing debt and it does not capture the "completeness" of the market, as maturities are uneven due to past issuance patterns. Another discussion point was whether the Treasury portfolio characteristics should be considered net of financial assets, primarily direct student loans. The Committee reviewed several alternative metrics and base case forecasts that could enhance Treasury's debt management tools and provide greater transparency in their public communications, while noting the importance of maintaining flexibility. After a robust conversation, the Committee agreed that WAM is best used in conjunction with other measures. Regardless of the metrics used, the Committee underscored the importance of clearly articulating Treasury's debt management strategy and objectives and the factors that impact issuance patterns.

The Committee's third charge was to comment on the use of buybacks during a time of budgetary deficits and whether such a tool could be used to assist Treasury in managing the maturity structure of debt portfolios, secondary market liquidity, and cash balance. In the 2000 to 2002 period, Treasury conducted buybacks through reverse-auction operations in response to shrinking financing needs and the desire to maintain new debt issuance sizes to ensure market liquidity of those issues. Without the buyback operations, any variation in funding needs must be met by changing gross debt issuance, a process that could be at odds with the Treasury's goal of being regular and predictable in issuance patterns. It was noted that buybacks could enhance the liquidity of new and off-the-run coupon Treasury issues, smooth the debt issuance pattern during times of overfunding, dampen the seasonal variation in Treasury bill issuance or cash balance, reduce the maturity peaks in the outstanding debt, and allow for more efficient adjustments to the Treasury debt profile. The Committee discussed certain issues in conducting debt buybacks such as the cost of operating on both sides of the market, the potential consequences of interfering with market function, and the accounting issues with purchasing premium priced securities as the premiums count as current expenditures and would increase the reported budget deficit, albeit at no true economic impact. In addition, premium debt buybacks would interact with the debt limit as the limit is measured on par debt. Other factors considered were the implementation process and the potential capacity of a Treasury buyback program. It was also noted that most other countries conduct debt buyback or debt exchange programs. One member suggested that bond exchanges may be a more efficient way to conduct debt strategy optimization. After a robust discussion, the Committee agreed that debt buybacks could be a valuable tool in debt management strategy to aid transitions in debt profile, enhance liquidity and smooth debt maturities, in particular as issues approach maturity. While not critical at this moment in time, the Committee recommends that Treasury continue to evaluate the efficacy of buybacks and bond exchanges.

TBAC Recommended Financing Table Q1 2015 and TBAC Recommended Financing Table Q2 2015