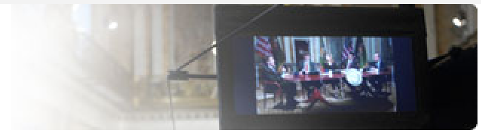
U.S. DEPARTMENT OF THE TREASURY

Press Center



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

2/3/2016

February 2, 2016

Letter to the Secretary

Dear Mr. Secretary:

Since the Committee last met in early November, economic activity decelerated noticeably but economic fundamentals remained solid. Annualized real GDP growth in the fourth quarter slowed to 0.7%, based on advanced estimates, compared to 2.0% in the third quarter 2015. The slowdown was broad-based, especially in fixed investment and government spending, while inventory accumulation and net exports subtracted from growth. Private consumption decelerated but was still sturdy. The job market continued to tighten, with sizeable increases in non-farm payrolls and the unemployment rate closed the year at 5%. Renewed declines in oil prices dampened the inflation outlook, but core measures held up relatively better. In this context, after seven years in the zero lower bound, the Federal Reserve increased the federal funds rate by 25 basis points in December without major mechanical difficulties. Since then, a deterioration in market sentiment led to sizeable drawdowns in global equity markets, declines in long-term U.S. Treasury yields, increased credit risk premiums and further trade-weighted U.S. dollar appreciation. After its January meeting, the Federal Reserve's statement referred to the moderation of activity and the impact of global developments on the labor market and inflation, while continuing to point to a data-dependent and 'gradual' hiking cycle.

Private consumption growth decelerated from 3.0% to 2.2% between the third and the fourth quarters. The boost to real disposable personal income from lower oil prices appears to have had a marginally decreasing effect on consumers' willingness to spend. Indeed, the savings rate stood at 5.4% in the fourth quarter, the highest since 2012. Still, consumption growth is likely to remain well supported by continued strength in durable goods outlays, one of the strongest areas of private consumption in recent quarters, and the perception that at least part of the oil price decline will persist. In addition, consumer confidence indicators remain near post-crisis highs, so far seemingly undented by stock market gyrations, and household balance sheets remain well supported by steady increases in home prices.

Inventory accumulation continued to decline during the fourth quarter and business fixed investment spending decelerated to a standstill. Nonresidential investment was particularly hard hit, declining by 1.8%. The structures equipment component contracted noticeably, and the equipment component declined for the first time since 2014. Weakness in the oil and gas sectors drove most of the negative contribution to GDP growth from these components, but the share of these sectors in GDP has declined markedly over the past couple of years. Moreover, the non-linear cost curve structure of US oil producers implies that renewed oil price declines are likely to have less of an impact on energy capex and overall growth going forward. Outside the energy sector, most surveys of business executives indicate that capital spending will increase modestly in 2016.

Housing sector indicators have mostly remained on the strong side. Measures of house prices reached new post-crisis highs, increasing at annual rates between 5-6% during most of the fourth quarter. Home sales have been solid---existing home sales bounced back in December after a slump precipitated by changes in mortgage rules, while pending home sales rose slightly to cap a year of solid growth. On the disappointing side, housing starts and permits declined in December, impacted by weather-related factors and volatile segments of the market, while homebuilders' sentiment declined slightly. Looking forward, momentum in housing should be supported by favorable demographic trends, low mortgage rates, and a tightening labor market.

Overall government spending decelerated during the fourth quarter, contributing only 0.1 percentage point from GDP growth. Although federal government outlays increased, these were partially offset by declines in state and local government spending. However, in 2016, government spending is likely to increase and contribute more meaningfully to growth. This follows an agreement between Congress and White House to give a moderate boost to federal spending during the next two years and the suspension of the debt ceiling through March 2017.

The resumption of the appreciation of the U.S. dollar over the past few months has hurt net exports. In the fourth quarter, exports of goods and services declined by 2.5%, while imports increased by 1.1%. As a result, net trade deducted nearly half of a percentage point from GDP growth. These dynamics are reflected in a noticeable weakening of the manufacturing sector, with overall industrial production declining sharply in the fourth quarter. The strengthening of the U.S. dollar accounts for some of this decline, but it is also attributable to a weakening of external demand arising from concerns around China's structural deceleration and its impact on the rest of the world, especially in other Asian economies and emerging markets at large.

Labor market indicators have remained strong. Nonfarm payrolls reached 292,000 in December, greatly surpassing expectations and bringing the quarterly sum to its highest level since the fourth quarter of 2014. Gains were widespread across industries, and especially strong in construction and services. Traditional and broader measures of unemployment that include marginally attached plus part-time workers reached post-crisis lows during the fourth quarter, even as the participation rate edged up. Labor compensation indicators, however, continue to show only tepid gains---with positive but moderate yearly changes in recent prints for average hourly earnings and the employment cost index.

In turn, inflation pressures have remained mostly subdued. Renewed declines in energy prices have kept headline inflation measures below 0.5%, but core measures have held up relatively better. The ex-food and energy core personal consumption expenditure deflator printed 1.4% (yoy) in the fourth quarter, while the core consumer price index rose to 2.1% (yoy) in December. Inflation expectations have declined recently, as signaled by both market and survey measures. However, moderate inflation pressures are likely to emerge as the impact from recent declines in energy and import prices fades, and as labor markets continue to tighten. In recent communications, the FOMC indicated its expectation for inflation to increase toward its 2% objective over the medium term.

The FOMC has also emphasized that economic conditions are likely to warrant only "gradual" increases in the target federal funds rate. In its January statement, it also alluded to the implications of global and financial developments on the balance of risks to the outlook. Markets interpreted this reference as a cautious stance in face of the recent tightening of financial conditions---stemming mostly from increased global financial volatility---and are only pricing 1-2 more hikes this year. However, some market participants think that unless economic activity or inflation data deteriorate significantly, or global risk aversion intensifies considerably more, the FOMC could resume hiking in March.

Against this economic backdrop, the Committee reviewed Treasury's February 2016 Quarterly Refunding Presentation to the TBAC. Treasury believes it prudent to increase the level of Treasury bills outstanding over the coming quarters. Given demand for high quality liquid collateral by market participants, the Committee agreed that Treasury bill issuance should increase, and that Treasury should continue to study the potential addition of two month Treasury bills. Demand for Treasury bills remains strong. If the Federal Reserve continues to reinvest the SOMA portfolio in FY2016 and coupon sizes remain at current levels, OMB is forecasting that Treasury will be overfunded by $118 billion. However, if the Federal Reserve allows the Treasury securities in the SOMA portfolio to mature, $675 billion maturing in the next three fiscal years, Treasury's borrowing need would increase significantly.

The Committee's next charge was to discuss potential adjustments to the auction calendar. The Committee continued its recommendation from the November 2014 meeting that Treasury increase its Treasury bill issuance in order to reduce interest expense, to enhance short-term market function, and to increase Treasury's operational cash balance. Treasury bill demand is expected to increase given demand for high- quality liquid collateral given money market and other regulatory changes. However, if Treasury were to significantly increase in Treasury bill issuance, it would likely need to reduce nominal coupon and TIPS issuance over the coming quarters. The Committee was tasked with recommending a framework to aid it in determining where to reduce issuance sizes across these securities and how best to communicate these decisions to the market. After a robust discussion, the Committee recommends that Treasury consider a gradual reduction in coupon and TIPS issuance size, on the order of $1 billion per auction per month, focused on maturities of 5 years and longer. The Committee recommends that Treasury evaluate whether further adjustments are necessary at future refunding meetings. In addition, there was a robust discussion regarding the cost effectiveness of TIPS issuance and some suggested TIPS auction sizes could be reduced more than nominal issues. Regardless, there was broad agreement that Treasury remain committed to TIPS issuance and that any adjustment to issuance size be gradual and flexible in light of uncertain Treasury funding needs.

The Committee's next charge was to consider whether greater public availability of data on transactions in the secondary market for Treasury securities would be beneficial to market liquidity. This question is consistent with the outstanding RFI that was released by Treasury on January 19th. The Committee agreed that the official sector should have broad and detailed access to transaction data. There was considerable discussion and debate about how detailed publically available data should be and how quickly those data should be made available. Several members commented that data transparency is just one component that is necessary to promote Treasury market liquidity. The Committee recommended that any decisions with regard to public dissemination of Treasury transaction data be informed by a full consideration of the public comments to the RFI.

Respectfully,

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Dana M. Emery
Chairman

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Curtis Y. Arledge
Vice Chairman

TBAC Recommended Financing Table Q1 2016 and TBAC Recommended Financing Table Q2 2016