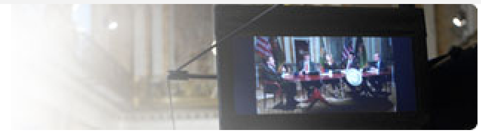
U.S. DEPARTMENT OF THE TREASURY

Press Center



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

5/4/2016

May 3, 2016

Dear Mr. Secretary:

Since the Committee last met in early February, the pace of economic activity has slowed noticeably. Annualized real GDP growth slowed in the first quarter to 0.5%, compared to 1.4% and 2% in the fourth and third quarters of 2015, respectively. While some of the weakness is owed to transitory factors such as a downward adjustment in the pace of inventory accumulation, the rate of consumer and capital spending growth also softened at the beginning of the year. The main detractor from first quarter GDP growth was a sharp contraction in gross private domestic non-residential investment. In spite of the downshift in the pace of activity growth, financial market conditions turned more favorable in the second half of the quarter, after risk appetite deteriorated significantly at the beginning of the year. Better Asian activity data, increased foreign central bank accommodation, and a more gradual expected path of Fed policy normalization all contributed to the improved tone in financial markets. The performance of the domestic labor market has remained solid and professional forecasters, on average, expect a return to modestly above-trend growth for the remainder of the year.

Consumer spending growth was restrained during the first quarter, expanding at only a 1.9% annual rate, and the saving rate moved up moderately to 5.2%, matching the highest level of the past three years. The decline in consumer spending growth came primarily from the durable goods category, while services spending contributed robustly to growth. Some of the rise in the saving rate may reflect caution as declining equity prices early in the year would be expected to exert some negative wealth effect. In addition, retail gasoline prices took another leg down early in the year - past episodes of declining gas prices suggest that the immediate impact is to increase saving, and only over time as the decline is seen to be lasting are the savings gradually redeployed into higher spending. Consumer sentiment measures generally softened over the course of the first quarter, but remain relatively elevated by the standards of this expansion. Household balance sheets are buttressed by rising home prices, with most measures increasing between 5 and 6% year-over-year. Contingent on continued health in the labor market, consumer spending is expected to firm somewhat as the year progresses.

Business fixed investment spending contracted at a 5.9% rate in the first quarter, as ongoing cutbacks in the energy sector once again weighed on overall capital spending. Energy business spending has been muted over the last two quarters, perhaps in response to increased global uncertainties. Residential investment growth accelerated to 14.8% - the fastest pace in three years. However, the pace of business spending on inventory investment slowed again last quarter – a development which subtracted 0.3% from overall GDP growth – though the level of inventory investment remains somewhat elevated. Business outlook surveys generally weakened over the past few months, with noticeable declines in new orders and shipments, reflecting a fragile recovery in the manufacturing sector. Going forward, the recent increase in energy prices and decline in the value of the dollar may give some support to corporate profits and manufacturing competitiveness, which should moderately brighten the prospects for capital spending.

Foreign trade subtracted 0.3% from GDP growth last quarter, and gross exports contracted at a 2.6% annual rate, the second straight quarter of contraction. While past dollar appreciation certainly plays a role, the ongoing deceleration in the manufacturing and exports sectors can also be attributed to weakness in external demand. During the first quarter, acute concerns around China’s structural downshift in growth, the impact of lower oil prices on emerging markets, and aggregate demand weakness in developed economies, are all likely to have contributed negatively to U.S. exports demand. While trade prospects remain subdued, there have been some encouraging developments recently. Chinese activity appears to have firmed some lately, likely in response to pro-growth actions taken by the Chinese government late last year and early this year. Consumer spending indicators have picked up in the euro area recently, as well as in Canada and Mexico, our largest trading partners. Finally, the broad, trade-weighted value of the dollar has retreated about 6% from its January peak, a development which may restore some competitiveness to exporters.

During the first quarter, the contribution from government spending to growth was mixed. On the one hand, federal expenditures contracted by 1.6%, the first decline in five quarters, dragged by cuts in national defense outlays. On the other hand, state and local government spending increased by 2.9%, which more than offset the negative contribution from federal spending cuts. Over the next few quarters, agreements between Congress and the White House to give a boost to federal spending through 2016, and the suspension of the debt ceiling through March 2017, should fuel a moderately positive fiscal impulse.

Labor market developments remain robust: nonfarm employment increased by 209,000 per month, on average, in the first quarter. The unemployment rate remained at 5.0% in March, the same level that prevailed in the fourth quarter. In addition, the labor force participation rate has increased to 62.8% over the past six months, indicating that some of the cyclical headwinds generating labor market slack continue to abate. In turn, labor compensation indicators, including average hourly earnings, wages and employment costs, are showing moderate signs of improvement.

Consumer price inflation has remained subdued. The personal consumption expenditure (PCE) price index was up only 0.8% year-over-year, held down by ongoing declines in the price of energy. However, even the ex-food and energy core PCE index was up only 1.6% year-over-year. The lingering effects of past dollar appreciation and energy price declines have weighed on core inflation developments, though these influences should presumably wane in coming months. Survey-based measures of inflation expectations edged down but remain broadly stable, while market-based measure have picked up substantially from their lows early in the first quarter.

In recent months, Federal Reserve communications have served to lower the expected path of the federal funds rate. At its March meeting, the median FOMC participant expected only two rate increases this year, down from four at last December's Fed meeting. The statement released after the April FOMC meeting indicated a continued expectation for only gradual normalization. While global economic and financial risks have ebbed since the beginning of the year, low levels of inflation and inflation expectations have led to a cautious approach in proceeding with the rate normalization begun last December.

Against this economic backdrop, the Committee reviewed Treasury's May 2016 Quarterly Refunding Presentation to the TBAC. During the first quarter of 2016, tax revenues were weaker than during the equivalent period last year, while Treasury net expenditures rose due to higher interest expense and increased Medicare outlays. Treasury projects a net borrowing need of $687 billion for FY 2016. Between FY 2016 and 2018, Treasury's borrowing from the public would increase significantly if the Federal Reserve were to allow the SOMA Treasury securities to mature. Bid-to-cover ratios for FRNs and shorter-dated coupons have fallen moderately in recent months, while bills and longer maturity nominal have remained stable. Treasury's cash balance fell moderately to $314 billion at the end of the first quarter.

The Committee's first charge was to discuss potential adjustments to the auction calendar. The Committee continued to recommend an increase in Treasury bill issuance to support the demand for high quality liquid collateral in light of money market reform and other regulatory changes, as well as to build operational cash balances. The Committee discussed the current low uptake of the Fed's RRP facility but commented that usage may increase if policy rates continue to normalize. Given the current projection for increased borrowing requirements in FY 2017 and beyond, and the uncertainty regarding the Federal Reserve's plans regarding SOMA reinvestment, the Committee recommended that the current nominal and TIPS coupon sizes remain unchanged. Going forward, the Committee believes that Treasury has the flexibility to both increase Treasury bill issuance and maintain coupon issuance at current levels. The Committee recommends that this issuance profile be reviewed again in November after money market reform becomes effective.

The Committee also briefly discussed Treasury's RFI on the Evolution of the Treasury Market Structure. In particular the Committee focused on centralized trading data collection by the official sector and the potential dissemination of post-trade transaction details. The Committee is supportive of centralized trade data collection but views differed on post-trade dissemination. The Committee cautions that the benefits of greater transparency must be balanced against the potential impact on market participation and risk taking. There is considerable debate and uncertainty about the potential market impact from various approaches to enhanced public reporting, so any approach should be undertaken with considerable caution, allowing room for recalibration over time as new information is collected.

The Committee's next charge was to consider the extent to which fixed income dynamics in overseas markets have affected the demand for US Treasuries and to assess the challenges facing major sovereign borrowers, including the United States. One member prepared the attached presentation that reviewed the outlook for major economies outside the US, recent monetary policy actions, the record low yields and the collapse in term premia in core bond markets. Most advanced economies are experiencing slower growth and low inflation and forecasts have been revised lower, resulting in more aggressive policy responses. The ECB surprised the markets with a broad, expansive package of policy changes including more quantitative easing, more expansive collateral eligibility including corporate debt and a move to negative deposit rates. In January, the BOJ introduced negative rates. While demand for Treasuries remains strong, the demand base for Treasuries is shifting from foreign investors and the Federal Reserve to private domestic investors. Broker/Dealer auction participation has decreased while domestic fund participation has increased. Among foreign investors there is also a shift from the official sector to private investors and investors have termed out their purchases at auctions. In addition, the historical relationship between certain assets, including swaps and GC rates relative to Treasury rates, has changed, and certain measures of liquidity have deteriorated. European sovereigns have extended the average life of their debt amidst record low interest rates and expanded ECB policy moves, and have adopted more flexible issuance procedures. In the US, interest costs as a percentage of the total budget deficit are projected to rise and the rising debt-to-GDP ratio may limit flexibility to handle the next downturn. The potential unwind of the Fed balance sheet is a medium-term challenge as Treasury's borrowing from the public could increase significantly, with presumably more price sensitive investors. In addition, market structure and regulatory changes may continue to present a challenge. Given global dynamics, changes in the demand base, structural changes in the market and the growing projected net borrowing need over the coming decade, the Committee recommends that Treasury continue to study its optimal debt issuance profile, while remaining flexible to adjust as economic and market conditions warrant.

Respectfully,

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Dana M. Emery
Chairman

TBAC Recommended Financing Table Q2 2016 and TBAC Recommended Financing Table Q3 2016