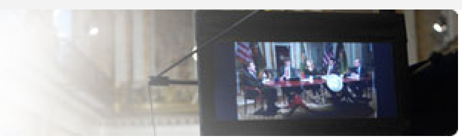
U.S. DEPARTMENT OF THE TREASURY

Press Center



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

8/3/2016

August 2, 2016
Letter to the Secretary
Dear Mr. Secretary:

The pace of overall economic activity in the first half of the year was subpar. Real GDP edged up .8% (annual rate) in the first quarter and the anticipated rebound in the second quarter is estimated to have been modest at 1.2% (annual rate). The headline figure in the second quarter masked significantly different performance among the major components of GDP, with robust consumption spending partly offset by declines in business fixed investment, inventories, and residential investment. The weakness in business fixed investment has lasted for three quarters, which is an unusually long soft patch during a business cycle expansion. Meanwhile, the declines in stock building and residential investment appear temporary.

Businesses have better aligned inventories with sales and housing starts should be buoyed by attractive mortgage rates, relatively tight months' supply of new and existing homes, and favorable trends in household formation. Looking forward, most professional forecasters expect a return to above-trend growth in the second half of the year as the drags from the business sector wane and household spending is supported by moderate increases in real income, strong gains in financial wealth, and solid sentiment.

In spite of the disappointment in second-quarter growth, financial market conditions eased significantly in the wake of the UK referendum on membership in the European Union. Immediately following the vote, the prices of risk assets fell sharply. Subsequently, risk assets enjoyed a general rebound, likely for a range of reasons including defensive positioning in advance of the vote, expectations of a supportive policy response, lack of immediate catalyst for financial dislocation, and some guarded optimism regarding the evolution of the actual exit.

Consumer spending growth jumped more than 4% (annual rate) in the second quarter and the saving rate moved down into the middle of the range that has prevailed in the last three years. All major categories of consumption expanded briskly with especially strong outlays on goods. Some of the decline in the saving rate may reflect an unwind of the unusual degree of risk aversion among households that had prevailed for the prior year. Consumer sentiment measures were generally sturdy during the second quarter at levels that support further above-trend increases in consumption. Household balance sheets have been flattered by rising home prices, a rebound in equity wealth back to record highs, and moderate growth in debt. Combined with the healthy labor market, the fundamental drivers of consumption suggest household spending will be the primary driver of the expansion as the year progresses.

Business fixed investment dropped at an annual rate of more than 2% in the second quarter on the heels of larger subtractions in the prior two quarters. Ongoing cutbacks in the energy sector continue to weigh on investment. In addition, weakness has also been seen in expenditures on information processing equipment and transportation equipment. Residential investment took a breather in the second quarter, easing approximately 6% (annual rate) after having expanded briskly for the prior two years. The major story in the second quarter was the outright drop in real private inventory investment, a move that subtracted 1.2 percentage points from overall real GDP growth. Inventory investment has been a significant drag on growth for five quarters. The retrenchment of stocks compared with sales appears to be nearing an end, which sets the stage for at least some inventory investment in the second half of the year. However, cautious business sentiment is a downside risk to any forecast for improved capital expenditures and inventory expansion.

Foreign trade added marginally to real GDP growth last quarter. Exports edged up at an annual rate of a little more than 1% and imports were about flat. With the external sector contributing modestly to first-half growth, it would appear that the worst of the impact of the significant appreciation in the exchange value of the US Dollar is behind us. Going forward, a broadly stable US Dollar and better activity data in advanced and emerging economies suggest better prospects for US trade. However, significant downside risks remain, notably from how the uncertainty stemming from Brexit unfolds and concerns about the outlook for growth in major economies like China, Japan, and the Euro area.

Government subtracted from growth during the second quarter. Defense outlays and state and local investment contracted, but an increase in overall government consumption was a partial offset. Over the next few quarters, looser state and local budgets and the agreement between Congress and the White House to give a boost to federal spending through 2016 as well as the suspension of the debt ceiling through March 2017, should fuel a modestly positive fiscal impulse.

After a scare in the May employment situation report, payroll employment surged in the June release. On net, payrolls are estimated to have risen over the two-month period by an average monthly pace of about 150,000. That pace represents a deceleration from the 200,000 average monthly increases in the first quarter. Despite the slowdown, economists estimate that increases in employment above an approximately 100,000 monthly threshold are more than enough to absorb slack in the labor market. At the same time, the unemployment rate ended the first half of the year at 4.9%, which is the same rate as at the start of the year. After initially moving up, the participation rate ended the first half of the year at 62.7%, the same rate as at the start of the year. In a remarkable coincidence, the broadest measure of labor market performance, the employment-population ratio, also ended the first half of the year at the same rate as the start of the year. Measures of labor compensation, including the most timely release on average hourly earnings, showed moderate increases that nevertheless significantly outpaced the very weak figures on productivity growth.

Consumer price inflation has remained subdued. The personal consumption expenditure (PCE) price index rose .9% over the last year, held down by soft energy prices. Apart from energy and food, core PCE prices moved up 1.6% (annual rate) in the first half of the year, an acceleration of 1/4 percentage point compare with last year. The lingering effects of past US Dollar appreciation and energy price declines have weighed on core inflation developments, though these influences should presumably moderate in coming months. Survey-based measures of inflation expectations edged down, on net, while market-based measures of inflation compensation bounced around close to record lows. Negative developments in various measures of inflation expectations have gotten the attention of policy makers, who have flagged them as potential downside risks to restoring inflation to its mandate-consistent rate.

In recent months, Federal Reserve communications have emphasized caution, a development that has served to lower the expected path of rate hikes. At its June meeting, FOMC participants generally lowered their expectations for the appropriate rate for the gradual withdrawal of monetary policy accommodation. At the July meeting, the FOMC statement hinted at diminished downside risks in the near-term, but was otherwise noncommittal. With global economic and financial risks still prevalent although diminished, low levels of inflation and inflation expectations, and subpar growth in the first half, such a cautious approach appears to be a feature of monetary policy as we move into the remainder of the year.

Against this economic backdrop, the Committee reviewed Treasury's August 2016 Quarterly Refunding Presentation to the TBAC. During the second quarter of 2016, corporate tax revenues have been weaker than during the equivalent period last year, potentially attributable to smaller corporate profits and the extension of bonus depreciation. Fiscal year to date, Treasury net outlays were $106 billion higher than last year, mainly reflecting larger interest expenses. In addition, Medicare expenditures were higher by $27 billion, importantly due to an $11 billion increase in payments made to prescription drug plans.

Treasury projects a net marketable borrowing need of $774 billion for FY 2016. This estimate includes a $151 billion year-over-year increase in Treasury's cash balance, which stood at $364 billion in June. In FY 2017, the Office of Management and Budget estimates that borrowing from the public will decline to $572 billion. In terms of risks to the baseline, the Treasury's borrowing from the public could rise sizably if the Federal Reserve ceases reinvestment of maturing Treasury securities held in the SOMA portfolio. In terms of portfolio metrics, bid-to-cover ratios for TIPS and shorter-dated coupons have fallen significantly in recent months, while bills have been little changed. By contrast, longer-dated coupon bit-to-cover ratios are broadly higher.

The Committee's charge was to discuss cybersecurity and make specific recommendations to Treasury about how to mitigate cyber threats. One member reviewed the threats faced by governments, businesses, and households. It was noted that the largest data breaches have occurred at financial firms and government organizations, a fact that underlines the importance of the integrity of the Treasury auction process. Best practices for cybersecurity were reviewed. Turning to Treasury auctions, another member reviewed prior examples when unforeseen incidents disrupted regular market operations. In terms of cyber threats, the Treasury's TAAPS system is potentially exposed to cybersecurity risks. The Treasury's current resiliency plan involves multiple locations and annual testing with a manual phone-based contingency when TAAPs might be unavailable. At the conclusion of the presentation and discussion, the Committee unanimously recommended that in addition to testing the phone-based contingency through mock auctions, Treasury should periodically conduct small-scale live auctions of its phone-based contingency system. The Committee also unanimously recommended Treasury consider alternative independent secured communications systems for dealers to submit encrypted files as a contingency bidding process when TAAPS is unavailable. Finally, the Committee suggested Treasury space auctions so that there's at least one business day between auction and settlement.

Respectfully,

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Jason G. Cummins
Chairman

TBAC Recommended Financing Table Q3 2016 and TBAC Recommended Financing Table Q4 2016