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

August 2, 2017

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Letter to the Secretary

Dear Mr. Secretary:

Economic activity picked up in the second quarter after a sluggish first quarter. Real GDP rose 2.6% (annual rate) last quarter, led by healthy gains in personal consumption expenditures and business fixed investment. Smoothing through the quarterly variability, real GDP has expanded 2.1% over the last four quarters. That pace represents a continuation of the relatively slow but steady growth that has characterized this expansion.

Since the Committee last met in May, the Federal Open Market Committee (FOMC) raised interest rates again, outlined a plan for how it will shrink its super-sized balance sheet, and suggested it would begin the run-off "relatively soon," which most market participants interpreted as the next FOMC meeting in September. In spite of these moves to provide less monetary policy accommodation, financial conditions eased on net. Equities rose on good news about earnings, the broad trade-weighted exchange value of the US dollar fell as growth improved abroad, and long-term interest rates were little changed. Financial conditions are expected to remain accommodative in the near term, continuing to support domestic economic activity and provide a favorable backdrop for the ongoing economic expansion.

Real personal consumption expenditures increased 2.8% in the second quarter, somewhat stronger than in the first quarter. Spending on durable goods rose briskly despite sagging sales of motor vehicles. Nondurable spending also notched a solid gain while growth in services was steady. The most recent readings on the consumer have been mixed. Core retail sales (excluding autos, building supplies and gasoline stations) fell outright in June, which provides a weak handoff to the current quarter. However, industry reports suggested motor vehicle purchases edged back up in July. Looking ahead, the fundamental determinants of consumer spending appear sturdy. Consumer sentiment is elevated, household balance sheets have enjoyed rising home and equity prices, debt growth has been disciplined, and compensation growth has been moderate.

Business fixed investment moved up 5.2% in the second quarter, improving across the board in equipment, structures, and intellectual property. Real outlays on equipment accelerated to 8.2%, the largest increase since the third quarter of 2015. Real structures investment increased 4.9%, a move that was more than all accounted for by a surge in drilling activity in the energy sector. Real investment in intellectual property slowed because of a decline in the entertainment sector. Looking forward, national and regional surveys of purchasing managers point to ongoing momentum in manufacturing and investment. In addition, hard data on orders of nondefense capital goods excluding aircraft have improved further in recent months, and remain above the corresponding shipments, which is positive for further growth in equipment investment. Inventory investment was nearly unchanged in the second quarter. The real level of -$0.3 billion means that there is plenty of room for sizable positive contributions to growth in the second half of the year as businesses restock.

Real residential investment declined 6.8% in the second quarter. Part of the decline may owe to payback from the large increase in the first quarter when unseasonably warm weather pulled forward activity. Despite the decline, fundamentals in the housing market look generally positive. The benchmark 30-year mortgage remains below 4%, credit is widely available, and the supply of new and existing homes is relatively lean.

Net exports added a little to second-quarter real GDP growth. With the broad trade-weighted exchange value of the US dollar depreciating by 7% this year, the dollar is turning into a tailwind for growth. At the same time, the outlook for global growth has brightened. Developed market economies have displayed surprising strength, especially in the Euro area, and emerging market economic performance has been stable as worries have faded about downside risks to growth in China. As a consequence, we look for stronger US exports in the coming quarters

Government spending and investment rose a bit in the first quarter. Federal outlays increased a little more than state and local contracted. Plans for federal expenditures on health care and tax reform continue to be debated by Congress and the administration. Efforts to repeal and replace Obamacare have been unsuccessful so far. An outline for tax reform was agreed among key officials and the relevant committees in Congress will forge ahead on filling in the details in the fall.

Despite relatively slow growth, the labor market has continued to impress. The unemployment rate has fallen 0.3 percentage points in the first half of the year to 4.4%. Over the same period, nonfarm payroll employment has averaged a robust 180,000 new jobs per month. Despite what appears to be a tightening labor market, wage growth has been modest. Average hourly earnings have slowed to a 2.5% clip over the year ended in June. Over the same period, a broader measure of compensation in the employment cost index has been similarly muted. Part of the explanation for restrained wage growth may owe to historically weak productivity trends.

Consumer price inflation has disappointed over the past few months. Total personal consumption expenditures inflation ticked down to 1.6% in the year ended in the second quarter. Inflation excluding food and energy has been even weaker slipping to 1.5%, owing mostly to a string of idiosyncratic and transitory factors. Earlier in the year, a huge decline in the quality-adjusted prices for wireless phone services shaved .1 percentage points by itself from core inflation. More recently, volatile categories like airfares and lodging held back core inflation. However, some of the decline in core inflation looks more persistent, as owner's equivalent rent (the largest share of expenditures after health care) has slowed as well. Meanwhile, survey-based measures of inflation expectations bounced back to the middle of the ranges seen in the last few years. Market-based measures of inflation compensation have generally followed the path of longer-term nominal interest rates, declining for most of the year until bouncing back in the last month or so.

At its June meeting, the FOMC raised the federal funds rate for a third consecutive quarter to a range of 1.0% to 1.25%. The Fed also indicated that it expects to continue raising interest rates gradually. The median of the Committee participants' submissions of the appropriate path of policy called for three rate increases in each of 2018 and 2019 with a longer run neutral rate of 3%. The FOMC also announced in June detailed principles about how it plans to normalize its balance sheet. The Fed will decrease its reinvestments of principal payments on Treasury and agency mortgage-backed securities subject to a series of caps. For Treasuries, the cap will be $6 billion per month initially and will increase in steps of $6 billion at three-month intervals over 12 months until it reaches $30 billion. For agency mortgages, the cap will be $4 billion per month initially and will increase in steps of $4 billion at three-month intervals over 12 months until it reaches $20 billion per month. Although no decisions were made about the ultimate size of the balance sheet, the near-term path of the gradually declining balance sheet appears to be on autopilot. At their July meeting, the FOMC indicated that normalization would begin "relatively soon," code words most market participants took to mean an announcement in September with commencement soon thereafter. Given the very deliberate approach the Fed has taken to withdrawing accommodation, it seems likely they will pause on raising interest rates when they start balance sheet normalization. In light of the surprising shortfall in inflation from the Fed's 2% mandate, such a pause also enables the Committee to evaluate inflation trends before raising rates again. Most officials appear comfortable with returning to rate hikes in December,

Against this economic backdrop, the Committee reviewed Treasury's August 2017 Quarterly Refunding Presentation to the TBAC. Fiscal year-to-date receipts are up 2%, due to stronger individual income and payroll taxes. Fiscal year-to-date Treasury outlays increased by 6%.

Based on the Quarterly Borrowing Estimate, Treasury's Office of Fiscal Projections currently projects a net marketable borrowing need of $96 billion for the fourth quarter of FY 2017, with an end-of-September cash balance of $60 billion. For the first quarter of FY 2018, net marketable borrowing need is projected to be substantially higher at $501 billion, with a cash balance ramping up to $360 billion by the end of December.

The Committee reviewed the Treasury's cash balance policy in light of prudent risk management goals as well as developments related to the debt limit impasse, including the Secretary's recent letter to Congress saying it must act to increase the debt limit by 29 September. The Committee stressed the urgency and importance for Congress to raise the debt limit in a timely manner.

The TBAC charge was to discuss the implications for Treasury debt management from the Federal Reserve's potential normalization of its SOMA portfolio. The wide-ranging charge covered three major topics: Expectations for balance sheet normalization, options for the resulting increase in Treasury issuance, and potential broader market implications.

The FOMC is expected to begin phasing out reinvestments starting in October. Assuming a steady state where reserve balances are $650 billion (which includes a buffer than may prove unnecessary), the balance sheet will reach normal levels in the first quarter of 2021. At that time, Treasury holdings will be $1.7 trillion, down from $2.5 trillion presently. After normalization, the Fed is assumed to reinvest all maturing Treasuries on a pro-rata basis across the Treasury curve. Maturing mortgage-backed securities are assumed to be reinvested in T-bills. The Fed's holdings of Treasuries will grow by $100-200 billion per year in 2021 and thereafter. Over this period of normalization, the impact on 10-year term premium is estimated to be a relatively modest 40 basis points, but that will depend on the Treasury's issuance strategy as well as empirical relationships that are highly uncertain given the unique nature of this policy.

In addition to the funding gap created by less reinvestment by the Fed, the amount of maturing debt that needs to be refinanced will rise in the coming years. Another important variable for judging Treasury's funding needs is the path of future budget deficits, a topic about which there's considerable uncertainty. If the median deficit forecast by the primary dealers is a good guide, Treasury's borrowing needs are likely to be substantially higher over the coming years. In the baseline estimates, borrowing needs will increase from $525 billion in calendar year 2017 to $1,010 billion in calendar year 2020, effectively a doubling. Assuming a gradual ramping up in T-bill's share of overall debt, offering amounts excluding T-bills will have to rise by $672 billion by calendar year 2020. Assuming a more favorable profile for the federal deficit—such as in the administration's forecast—results in meaningfully lower offering amounts.

The presentation then turned to how Treasury should consider responding to increased funding needs. The highlight of the findings is that Treasury should consider increasing auction sizes across all tenors while gradually increasing T-bills as a share of overall debt. Under this proposal, the weighted average maturity (WAM) of the debt would gradually increase. Several other scenarios were presented. For example, were Treasury to concentrate increases at the front end of the Treasury curve with a large jump in the T-bill share to 22% of outstanding, coupons would increase only modestly.

The higher borrowing needs are primarily driven by the federal deficit, so Treasury should carefully consider fiscal policies as it makes decisions about various debt management scenarios. Nevertheless, if the median primary dealer forecast is a good guide, a prudent and flexible approach would consider increasing coupon debt as soon as the November refunding and as late as the first quarter of 2018. In particular, the presentation recommended that Treasury consider a broader increase in issuance across tenors.

The presentation concluded with a discussion of potential spillovers and risks from the normalization of the Fed's balance sheet. The private sector piggy-backed on the Fed's large-scale asset purchases, a move that promoted a surge in corporate borrowing and tighter risk spreads. In this environment, a tail risk stress scenario is that a small increase in yields could possibly lead to large changes in risk premiums. In an adverse scenario, there's the possibility of a meaningful, but not systemically risky, decline in both credit and equities.

In the ensuing discussion among Committee members, there was unanimous agreement that the traditional way of responding to cyclical debt needs by relying primarily on short-end funding would be inappropriate. Given the potential magnitude of the funding gap going forward, the Committee strongly recommends that Treasury consider a broader increase in issuance across tenors.

Although the Committee did not make specific recommendations for how to increase coupon issuance, there was unanimous agreement that the WAM should remain about the same or increase going forward. It was stressed by many members that the WAM is just a metaphor for Treasury's specific goals for least cost issuance and interest rate risk mitigation over time. In future charges, the Committee plans to carefully examine different debt management strategies within a model-based framework along with using WAM. The risk is that by using WAM as a single metric exclusively, the market mistakenly infers that a mechanical increase in longer-term coupons is optimal. It's not.

In terms of the timing of increased coupon issuance, the Committee felt that Treasury should consider increasing coupon debt as soon as the November refunding and as late as Q1 2018. By legging into increased coupon issuance relatively soon and in a predictable manner, Treasury maintains flexibility to respond to fiscal and other developments without causing market stress.

Respectfully,

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Jason G. Cummins

Chairman

TBAC Recommended Financing Table Q3 2017 and TBAC Recommended Financing Table Q4 2017