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

January 31, 2018

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Letter to the Secretary

Dear Mr. Secretary:

Since the Committee last met, the Federal Open Market Committee (FOMC) in December raised the target range for the federal funds rate to 1.25% to 1.5%. As confidence in the domestic and global economy has improved, the odds of further increases in fed funds have risen with investors expecting between two and three further rate increases this year with another increase thereafter. Nevertheless, financial conditions have eased significantly. Since the last refunding, the equity market is up more than 10%, the broad trade-weighted exchange value of the US dollar has depreciated by 4%, and credit markets have been healthy. Meanwhile, the Fed's program to normalize its balance sheet is proceeding in the background.

Against this favorable financial backdrop, the US economy enters its ninth year of expansion with renewed dynamism. The aging business cycle would typically be displaying late-cycle dynamics of slower growth and rising inflation. However, this cycle is defying that pattern. Economic activity appears to be accelerating further above trend and inflation pressures are only beginning to emerge. Despite the age of the business cycle, the data suggest that this cycle is behaving in a mid-cycle fashion paced by improved consumption and investment.

Economic growth in the fourth quarter was solid. Real GDP expanded at an annual rate of 2.6%, led by strong gains in personal consumption expenditures, rising spending on business fixed investment, and a jump in residential investment. Over the past four quarters, real GDP rose 2.5%, a little better than its average pace over the past five years.

The recent strength in consumer spending owed to robust outlays on both durable and non-durable goods; growth in services spending has been steady. Households appear much more confident about the outlook. As a result, the personal saving rate declined in December to 2.4%, its lowest rate since 2005.

Business fixed investment rose at an annual rate of 6.8% in the fourth quarter, primarily reflecting another double-digit increase in real equipment spending. While real structures investment was little changed, investment in intellectual property expanded by 4.5%. Looking forward, orders and shipments of nondefense capital goods have increased in recent months, and in the most recent data the level of those orders remains above shipments, which bodes well for future capital expenditures. The change in inventory investment subtracted 0.7 percentage points from overall GDP growth in the fourth quarter. Given the low level of inventory investment, businesses will probably have to rebuild stocks in the first half of the year, which will add to real GDP growth. Consistent with that assessment, manufacturing surveys remain at generally high levels.

Among the softer spots for growth recently, net exports subtracted 1.1 percentage points from real GDP growth in the fourth quarter. While exports rose at a nearly 7% clip, imports rose at about twice that pace. Despite the arithmetic subtraction from growth, the news from the external sector is generally positive as healthy exports reflect an increasingly strong global economy and brisk imports suggest a vibrant domestic economy.

Government spending and investment picked up in the fourth quarter. Federal outlays continued to increase because of defense expenditures. State and local governments' spending has been choppy in the last few years, but moved up because of a significant increase in fixed investment. Federal tax reform was enacted at the end of last year. According to many estimates, the combination of individual and business tax cuts will raise the level of real GDP by about 1% in the next few years, perhaps add to the potential growth rate of the economy, and significantly increase the federal deficit as many of the tax benefits are front-loaded.

In the labor market, the unemployment rate averaged 4.1% in the fourth quarter, a very low level by historical standards and somewhat below most economists' estimates of its long-run sustainable rate. Nonfarm payroll employment averaged 200,000 in the fourth quarter. At that pace, the unemployment rate promises to decline further still in the coming months. Average hourly earnings have been volatile recently. Smoothing through the ups and downs, the increase over the past year is a tepid 2.5%, partly reflecting subdued trends in productivity growth. Looking forward, the prospects for wage gains may be flattered by the business tax reform as a number of companies announced larger pay packages in the wake of its passage.

Following weak readings earlier in the year, consumer price inflation accelerated at the end of the year. Total personal consumption expenditures inflation rose at an annual rate of 2% in the final three months of the year. Excluding food and energy, prices rose at an annual rate of 1.9% over the same period, bringing the year-over-year change to 1.5%. When the price declines related to unlimited cell phone data plans drop out of the year-over-year calculation in the spring, the trend in core inflation should firm by another few tenths. Measures of inflation expectations have generally moved up. Since the last refunding, market-based measures of inflation compensation bounced roughly 25 basis points to more than 2%. Survey measures have been mixed with the University of Michigan long-term inflation expectations little changed at 2.5% and the New York Fed's three-year-ahead expectation rising to 2.9%.

In light of this financial and economic backdrop, the Committee reviewed Treasury's January 2018 Quarterly Refunding Presentation to the TBAC. In the first quarter of FY 2018, total receipts rose 4% from the year earlier as the increase in withheld income taxes from a stronger economy more than offset the decline in corporate taxes which appeared to owe to timing payments in anticipation of the passage of tax reform. Total outlays over the same period increased 5%. Based on the Quarterly Borrowing Estimate, Treasury's Office of Fiscal Projections currently projects a net privately-held marketable borrowing need of $441 billion for Q2 FY 2018, with an end-of-March cash balance of $210 billion. For Q3 FY 2018, net privately-held marketable borrowing need is projected to be smaller at $176 billion, with a cash balance of $360 billion at the end of June.

After Treasury's review of the feedback from primary dealers it was noted that there was substantial interest in introducing a 2-month T-bill. The 2-month point has the potential to meet significant demand without cannibalizing other short-term instruments. There was also interest in adding an additional settlement cycle for T-bills if a new tenor were to be offered. In light of these observations, it was agreed that at the next refunding the TBAC will study the prospects for introducing a 2-month T-bill.

The committee then turned to a discussion of the projected path of debt supply over the coming years. While the market commentary in the inter-refunding period rightly focused on the importance of the TBAC's work on a new model for optimizing debt management, the committee reiterated the big picture point that Treasury will need to increase issuance across the whole range of maturities given the large funding gap between current issuance and expected deficits. The members then turned to a discussion on the strategy and timing for how to meet the financing gap in the coming quarters. In terms of the strategy, members reaffirmed that the intuition from the modeling framework shaped their views about specific recommendations. Specifically, increased issuance should favor T-bills and the belly of the curve—recalling that the "belly" is defined as 2s, 3s, and 5s—along with longer-term issuance. While the WAM is just an outcome of an issuance strategy and not a goal in and of itself, it was noted that there was no particular bias to change the WAM going forward. Rather, an issuance strategy that's skewed to favor the belly of the curve would keep the WAM roughly around its current value, give or take a few months.

The TBAC charge was to assess the TIPS program and make recommendations for future issuance. The first presenting member discussed supply-side considerations. Ex-post cost estimates show the TIPS program has benefited Treasury relative to nominal securities. Nevertheless, ex-ante estimates going forward point to a diminished future benefit of the program if the decline in inflation risk premiums persists. According to the member, the factors that have held down inflation risk premium partly owe to business-cycle dynamics that are likely to fade overtime. If so, the Treasury should be able to maintain the current share of TIPS issuance in a regular and predictable manner and still capture some inflation risk premium going forward.

The second presenting member discussed demand-side considerations. Foreign holdings of TIPS have increased with room to grow further. Much of the increase in foreign demand emanates from offshore financial centers and appears to reflect the growth of asset managers specializing in 'risk parity' strategies. Domestic demand has also risen, with sharp increases in target-date funds. It was noted in the presentation that including TIPS in the broader bond indices would significantly boost demand.

Given the generally good performance of the TIPS program, the presenting members recommended that the Treasury should maintain the current share of TIPS issuance of about 7% over time. Given the size of the funding gap in the coming years and the general need to increase issuance across the board, TIPS issuance should increase over the coming years along with nominals. In calibrating the size of the increase, the presenters emphasized that an initial increase over the next year should balance the desire to increase gross issuance and minimize market disruption from doing too much at once. Given the uncertainty attendant in the fiscal outlook, it doesn't make sense to be too precise about the exact size of the increase, but something on the order of up to $26 billion might achieve those objectives. In terms of the tenors, a careful analysis showed that increases should be tilted toward the 5-year point, given more robust liquidity and demand.

In terms of specifics, Treasury could add a new October maturity 5-year TIPS. It was argued that would achieve a good balance of evening out the calendar and seasonality points as well as avoiding fragmenting the market into too many smaller, less-liquid issues. The 5-year TIPS auction could be added to the months with 30-year TIPS in October, February, and June and auctioned in the same week. The presentation illustrated the proposal with a stylized hypothetical auction calendar and showed how it might achieve a $26 billion increase in gross TIPS issuance over the coming year.

In the ensuing discussion, the members reemphasized the point that in the face of very large and likely persistent funding gaps, the gross issuance of TIPS should keep pace with the increase in nominal issuance. There was a free flowing debate on exactly how to engineer such an increase. It was noted that the stylized hypothetical auction calendar in the presentation was not to be taken too literally as Treasury may wish to study a range of potential options.

Lastly, you will note that we have delinked the TBAC recommended refinancing tables from this letter. In the prior refunding in November, some market commentators focused on the tables for specific guidance about Treasury's expected issuance in the following quarter. It is a mistake to use the tables for precise predictions. It is this letter and the minutes of the TBAC meeting that should be the focus of attention for our recommendations. The refunding tables should be considered as illustrative examples rather than any kind of exact policy guidance.

Respectfully,

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Jason G. Cummins

Chairman