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

May 2, 2018

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Letter to the Secretary

Dear Mr. Secretary:

Economic activity slowed in the first quarter of the year, following robust 3% annualized GDP growth in the second half of 2017. Looking ahead to the remainder of 2018, a reacceleration is widely expected, paced by the fiscal stimulus from recently enacted tax and spending legislation.

Soon after the Committee's last meeting, financial markets faced a bout of volatility in early February. The prospect of higher wage and price inflation pushed up interest rates which in turn sparked concerns over equity market valuations. Stocks fell nearly 10% and measures of market volatility jumped. Equity markets have since recovered somewhat, but volatility has remained higher as market participants voice concerns over inflation, trade negotiations, and geopolitical tensions.

Short-term interest rates have moved higher over the intermeeting period, as investors have nudged up their expectations for interest rate increases from the Federal Reserve over the next three years. The March Federal Open Market Committee (FOMC) meeting revealed a more optimistic Committee outlook for growth and modest upward revisions to the inflation forecasts in the Summary of Economic Projections. The assumptions of the appropriate path of policy showed the median FOMC participant raised the amount of assumed tightening at the end of 2020 from 3.1% to 3.4%. In addition, the LIBOR spread to overnight-index-swap (OIS) rates widened significantly. While the temporary surge in T-bill issuance likely contributed to the pressure, another explanation suggested that tax-induced earnings repatriation may have played a role as well. Farther out the Treasury curve, 10-year yields reached 2.94% in February, retreated following the equity market volatility, and, more recently, crossed above 3.0% for this first time since 2014. Nevertheless, overall financial conditions continue to be accommodative, on net.

Turning back to the details of growth in the first quarter, real personal consumption expenditures inched up at an annual rate of 1.1%, slowing from the brisk fourth-quarter rate of 4.0%. However, retail sales rebounded in March following a weak January and February that may have reflected technical changes in the timing of federal tax refund payments in the first quarter. Real consumer spending growth is widely expected to improve in the second quarter, in part helped by reduced withholding for income taxes following the reduction in individual tax rates. Despite the market volatility and lower equity valuations, consumer sentiment measures have remained elevated and sit near expansion highs. Household balance sheets have also been buoyed by rising home prices, and disciplined debt growth. Those strong fundamentals, combined with ongoing gains in employment and wages, suggest household spending will continue to support the expansion in the coming quarters.

Business fixed investment continues to expand, rising 6.1% at an annual rate in the first quarter. That follows a similar increase over the four quarters of 2017. However, the high frequency data on orders and shipments of nondefense capital goods have leveled off, suggesting something of a pause in the growth in equipment spending. By contrast, residential investment was flat in the first quarter, the slowing in part payback from the preceding quarter's strength. Builders' expectations appear to be positive for the remainder of the year, even in the face of somewhat higher borrowing rates on residential mortgages. The contributions to growth from inventory investment have swung widely the past few quarters, but overall most signs suggest little excess, implying inventories should not weigh materially on growth on average over the next few quarters.

Net exports were a small contribution to first quarter GDP growth. Looking ahead, net exports seem an unlikely source of material growth for the US economy. Heightened trade rhetoric could have knock-on effects to corporate and consumer confidence that might negatively affect investment and spending. The actual actions that have followed the recent tougher trade stance of the U.S. have targeted certain goods and commodities, such as steel and aluminum, pushing up input costs for some users. From a macroeconomic point of view, the costs are tiny relative to the overall size of the U.S. economy. Most economic analysts suggest the downside risks of wider trade restrictions or tariffs bear watching, but the magnitude of current actions have yet to rise to a level that would materially affect the economic outlook for the U.S. or global economy.

An important reason the outlook for the economy in the near-term looks quite favorable is because fiscal stimulus in the coming quarters should help keep growth above what underlying structural trends would imply. In addition, the Bipartisan Budget Act signed in February lifted federal government spending caps. Combined, these two pieces of legislation will boost growth in the coming several quarters, and have contributed to wider deficit projections by many analysts and the Congressional Budget Office (CBO). The CBO recently reported it expects GDP growth to reach 3.3% this year and 2.4% next year.

Above-trend economic growth over the past year has promoted a solid labor market expansion. Nonfarm payroll employment has averaged about 200,000 jobs a month to start this year. At the same time, the unemployment rate has held steady at a very low 4.1% in the last six months. The labor force participation rate has continued to bounce sideways in the same range that it has occupied for the last few years, a positive development against the backdrop of population aging that would otherwise suggest structural decline. Wage growth has trended up moderately despite widespread anecdotes of a tight labor market. Private wages and salaries measured by the Employment Cost Index have accelerated in recent years to get close to growth of 3% over the last four quarters, but a few other wage measures have generally remained range-bound.

Consumer price inflation has moved higher in recent quarters, including measures excluding food and energy. Headline personal consumption expenditures' prices rose 2.0% over the year ended in the first quarter, helped by higher energy prices. Inflation excluding food and energy moved up notably in March, reaching 1.9%, little different from the FOMC's 2% target. With the increase in oil prices and core inflation, market-based measures of inflation compensation have risen since last summer. Survey-based measures of inflation expectations are little changed in recent quarters near the bottom end of their historical range.

In light of this financial and economic backdrop, the Committee reviewed Treasury's May 2018 Quarterly Refunding Presentation to the TBAC. In the first half of FY 2018, total receipts rose 2% from the year earlier as the increase in withheld and non-withheld income taxes from a stronger economy more than offset the decline in corporate taxes. 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 $75 billion for Q3 FY 2018, with an end-of-June cash balance of $360 billion. For Q4 FY 2018, the net privately-held marketable borrowing need is estimated to be larger at $273 billion, with a cash balance of $350 billion at the end of September. It was noted that privately-held marketable borrowing excludes rollovers of Treasury securities held in the Federal Reserve's System Open Market Account, but includes financing required due to SOMA redemptions.

The Treasury team summarized the main findings from their meetings with primary dealers in advance of the refunding. There was significant interest among market participants in potential changes in the TIPS program and the effect of the increase in T-bill issuance in the intermeeting period.

Consistent with TBAC's prior recommendation to maintain the current share of TIPS issuance by expanding the 5-year tenor, investors generally agreed that such an increase would be well received by the market. However, there was a range of views on how to operationalize such an increase, with some favoring larger auctions in order to increase liquidity and others arguing for spreading out the issuance across the calendar by adding a new CUSIP. TBAC recommended that Treasury conduct further outreach in the coming months in order to assess how to best operationalize an increase in TIPS at the 5-year tenor.

With regard to the recent increase in T-bill issuance, the Committee unanimously agreed that rebuilding the cash balance was of critical importance to avoid operational risk posed by a potential interruption in market access. The debt limit forced Treasury to shrink the cash balance to operationally undesirable levels. Combined with the seasonal demands from tax refunds, the Treasury had to ramp up T-bill issuance very significantly. Going forward, Treasury's forecasts suggest that T-bill issuance will stay relatively flat for the rest of the fiscal year. Members emphasized the importance of maintaining the cash balance consistent with its recommended buffer, and the need to rebuild it following disruptions caused by the debt ceiling.

The Committee then turned to a discussion of the projected path of debt supply over the coming years. 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. Guided by TBAC's work on a model for optimizing debt management and based on current fiscal forecasts, the Committee suggested an illustrative roadmap for issuance in the coming quarters and into FY 2019. In particular, given the larger projected financing gaps, TBAC recommended an across-the-board increase in coupons, with 2s, 3s, and 5s favored compared with 7s, 10s, and 30s. A possible path would be to increase auction sizes for FRNs, 2s, 3s, and 5s by $1 billion per month and 7s, 10s, and 30s by $1 billion per quarter. Extending such a path into FY 2019 and maintaining the current TIPS share of issuance would enable Treasury to fund the currently expected financing gap in FY 2019 while slowly and predictably legging into greater coupon sizes. Such a strategy would maintain Treasury's flexibility to respond to any changes in fiscal assumptions and ensure a smooth transition to historically large auctions.

The TBAC charge was to assess the demand for a 2-month T-bill tenor, as well as the settlement cycle for this potential offering. The public debt is expected to rise considerably in the coming decade. TBAC has previously recommended that between one-quarter and one-third of the financing gap should be met with T-bill issuance. For the avoidance of doubt, the study of the potential 2-month tenor is not meant to signal any additional bill issuance beyond what was already recommended in the past. Rather, the 2-month bill would allow Treasury to meet investor demand and diversify funding sources while controlling the growth of auction sizes.

The first presenting member reviewed the literature that emphasized the desirability of issuing more bills given the existence of a T-bill premium to a hypothetical curve fitted with coupons. Confirming prior research, the member found that T-bills trade at a premium to the Treasury yield curve. Furthermore, the premium is most pronounced at the front-end of the T-bill curve. By introducing a 2-month bill, Treasury could enjoy significant investor demand and help diversify its sources of funding.

The second presenting member considered various details on potential settlement. The member recommended adding an additional settlement day when introducing the 2-month bill and pairing it with the 1-month bill. The grouping of the 12-, 6-, and 3-month bills would remain unchanged. A Tuesday settlement would avoid holidays on Mondays and Fridays and help smooth out the spikes in overnight funding rates currently observed due to the concentration of settlements on Thursdays. The member also highlighted that an additional settlement date would reduce Treasury's settlement risk and improve cash management.

In the ensuing discussion, all members recommended introducing a new 2-month bill. In terms of the operational details, members debated the best way to introduce the new tenor and settlement cycle. TBAC recommended Treasury further study these operational issues in the coming months.

Respectfully,

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Jason G. Cummins

Chairman