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

August 1, 2018

July 31, 2018

Letter to the Secretary

Dear Mr. Secretary:

Economic activity picked up in the second quarter with 4.1% annualized real GDP growth, rebounding after a slowdown in growth in the first quarter of the year. Over the past four quarters, real GDP rose 2.8%, and growth is expected to remain strong over the remainder of 2018, with a continued fiscal boost after recently enacted tax and spending legislation.

Since the Committee's last meeting, the Federal Open Market Committee (FOMC) raised the target range for the federal funds rate to 1.75%-2.0%. Financial conditions have tightened somewhat overall since the last refunding, but remain relatively accommodative. Equity markets have continued to trend upwards, largely recovering from a substantial fall in equity prices earlier in the year. The 2-year Treasury yield rose slightly as markets came to expect more tightening from the Fed. In contrast, the 10-year yield declined in May amidst concern about political developments in Italy and has remained in the 2.8-3.0% range in recent weeks, leading to a further flattening of the yield curve. The trade-weighted value of the US dollar has appreciated by around 4% since the start of May.

Consumer spending picked up in the second quarter, with real personal consumption expenditures growing at a 4.0% annualized rate. The increase in spending was broad-based, with durable goods spending increasing at a 9.3% rate, non-durables goods spending increasing at a 4.2% rate, and services spending increasing at a 3.1% rate. With consumer confidence and sentiment measures still high, and an additional tailwind from recently enacted tax cuts, consumer spending looks likely to remain strong in the upcoming quarters.

Business fixed investment rose at an annual rate of 7.4%, with broad-based increases in structures, equipment, and intellectual property. By contrast, residential investment decreased slightly; taken together with a recent decline in new home sales and existing home sales, housing momentum appears to have slowed down recently. The change in inventory investment subtracted 1 percentage point from GDP growth in the second quarter. The low level of inventory investment could lead to businesses rebuilding stocks over the second half of the year, leading to higher GDP growth. Manufacturing surveys remain optimistic, although the forward-looking components of the Philadelphia Fed manufacturing index, the Empire manufacturing index, and the Richmond Fed manufacturing index have all declined, potentially reflecting concerns regarding trade policy.

Net exports contributed 1.1 percentage points to real GDP growth in the second quarter, with exports growing at over a 9% clip and imports growing at less than a 0.5% rate. The increase in exports in Q2 appeared to partly reflect efforts to pull forward shipments, especially of agricultural products, in advance of retaliatory tariffs. Proposed tariffs against China increased significantly in size over the last two months. While the likely macroeconomic effects of the recently enacted tariffs and even the larger recent proposals appear limited, the most recent Beige Book of the Federal Reserve reports that manufacturers in all districts expressed increasing concerns about trade tensions, with some reporting higher prices and supply disruptions due to trade policy.

With the implementation of tax reform well underway, and the lifting of federal government spending caps in February, fiscal policy has boosted growth in the second quarter and will continue to do so over the next several quarters. Federal spending increased at a 3.4% annual rate over the second quarter, and state and local spending expanded at a 1.7% annual rate. The Office of Management and Budget has increased its 2018 federal deficit projection to 4.2% of GDP, with a further rise to 5.3% in fiscal year 2019.

The labor market has continued its solid expansion, with an average monthly gain in nonfarm payrolls of 215,000 since the beginning of the year. The unemployment rate has since dropped to 4.0%, and labor force participation has increased slightly. Wage growth has remained moderate, with average hourly earnings and the Employment Cost Index both growing at 2.7%

over the last year, partly reflecting low levels of productivity growth. The Federal Reserve's Beige Book reports widespread anecdotes of labor shortages, indicating the potential for rising wage pressures ahead.

Consumer price inflation has slowed slightly, with total personal consumption expenditures inflation falling to a 1.8% annualized rate over the second quarter. The core measure excluding food and energy fell to a 2.0% annualized rate, still in line with the FOMC's target. Most forecasters, as well as the FOMC, expect further gradual increases in core inflation, though not to levels that would be worrisome in the context of a symmetric 2% target.

The June FOMC meeting revealed an increasingly optimistic Committee outlook, with a slight further upward revision to the GDP projections, a further downward revision to the unemployment projections, and an upward revision to the inflation projections. Against this backdrop, the Committee lifted the amount of projected monetary policy tightening over the next two years, with 25bp increases in the median FOMC participant's funds rate projections to 2.4% at the end of 2018 and 3.1% at the end of 2019. The projected 2020 rate was unchanged at 3.4%. Financial markets and survey forecasters have likewise moved up their projections for the funds rate over the next several quarters.

The Fed's balance sheet normalization continues to gather pace, with caps on monthly runoff that are set to reach $30bn for Treasuries and $20bn for agency MBS next quarter. The FOMC has yet to provide clearer guidance on the ultimate size of the balance sheet, although most market participants expect shrinkage to the $3-$3.5 trillion range by 2020-21, followed by renewed slow increases in holdings thereafter.

In light of this financial and economic backdrop, the Committee reviewed Treasury's August 2018 Quarterly Refunding Presentation to the TBAC. In the first half of FY 2018, total receipts rose 1% 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 4%. Based on the Quarterly Borrowing Estimate, Treasury's Office of Fiscal Projections currently projects a net privately-held marketable borrowing need of $329 billion for Q4 FY 2018, with an end-of-June cash balance of $350 billion. For Q1 FY 2019, the net privately-held marketable borrowing need is estimated to be larger at $440 billion, with a cash balance of $390 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 Committee discussed the questions which were put forth to the primary dealers, notably on potential changes to TIPS issuance and the introduction of a 2-month bill. TBAC welcomed the dealer feedback that supported increased TIPS issuance including the potential for an additional 5-year original maturity. Notwithstanding TBAC's prior analysis of ways to facilitate increased TIPS issuance, members highlighted that issuing TIPS only once per month created a powerful liquidity event and further observed that the transition from the current calendar to Treasury's proposed Option 1 could have additional benefits. Moreover, the Committee highlighted that increasing financing gaps would require increases of both TIPS and nominal coupon issuances over time. The Committee recommended that Treasury continue to study the market feedback on potential changes to the TIPS program and provide guidance to the market at an upcoming refunding.

The Committee was pleased to see broad support for the addition of a 2-month bill and recommended Treasury use the opportunity of an increase in seasonal borrowing needs in the fall to launch the new benchmark in a size that would support secondary market liquidity. The Committee expected that an inaugural 2-month bill of at least $20 billion would be well received by the market place.

The Committee suggested further increases to coupon sizes would be needed based on current fiscal forecasts. TBAC reiterated its prior coupon issuance recommendation of a $1 billion per month increase in 2-, 3-, and 5-year notes and a $1 billion per quarter increase in FRNs, 7-, 10- and 30-year notes. This issuance strategy would also be broadly consistent with TBAC's prior recommendation that between one-quarter and one-third of the financing gap should be met with T-bill issuance. Based upon current fiscal projections, and expecting a gradual increase of TIPS issuance alongside the recommended share of T-bill issuance, TBAC expected that the proposed nominal coupon sizes over the August and November refunding would roughly meet the estimated financing needs for FY 2019. Given the uncertainty inherent in fiscal projections, Treasury will need to retain flexibility in its issuance path to respond to any changes in funding needs and ensure a smooth transition to historically large auction sizes.

The Committee noted that Treasury's recent approach of more heavily increasing 2- and 3- year notes but not 5-year notes has been more gradual than TBAC's recommendation. Given the muted market pricing impact, the increased supply has been well absorbed by the market. The

Committee noted that based on recent coupon increases and on primary dealer estimates of maximum issue sizes, there may be more capacity to increase issuance in 5-year notes and the longer part of the curve moving forward.

The Committee discussed a charge on how bank demand for U.S. Treasuries as a component of HQLA could evolve over the next 3-5 years given SOMA portfolio normalization. The Committee agreed that if the size of the Fed's balance sheet declined significantly, reducing the availability of Fed balances to meet Liquidity Coverage Ratio requirements, demand for Treasuries could increase substantially. This estimated surge in demand could develop across the yield curve, with a potentially larger than historical portion in bills, but estimates of the size of this demand were subject to a sizeable range of assumptions and uncertainty, given it is difficult to project how bank balance sheets will evolve. One member observed that many of the projections were based on historical patterns, but given the significant regulatory changes over the past 10 years, these patterns may have shifted. The member's presentation focused on bank demand specifically but members expected other demand would materialize as well. The Committee noted that this increased demand would be subject to many factors including the economic environment, level of rates, and shape of the yield curve amongst others.

The Committee also discussed a charge on the demand for mortgage-backed securities relative to U.S. Treasuries and the substitutability of these asset classes. The Committee broadly agreed with the presenting member that housing related securities are exposed to a range of risk factors which do not affect U.S. Treasuries, notably negative convexity from prepayment risk, and that these risk differences make agency MBS only weakly substitutable with U.S. Treasuries. The Committee agreed with the presenter's conclusion that conservatorship has reduced the credit risk premium associated with GSE debentures and MBS securities. However, LCR requirements have increased bank demand for Level 1 HQLA assets (including U.S. Treasuries and Ginnie Mae) and reduced demand for Level 2 assets (including Fannie Mae and Freddie Mac securities). The conclusion after a discussion of both charges was that as the Fed's balance sheet declines some demand would materialize for MBS securities, but more would materialize for Treasuries.

The Committee continued to review member work to enhance the optimal debt issuance model, and plans to provide a more formal presentation on additional enhancements later this year. Members working on the model noted that a paper detailing the model would be forthcoming by the end of the year. Members agreed that the model is one of several factors considered when recommending issuance to Treasury.

Respectfully,

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Beth Hammack

Chair, Treasury Borrowing Advisory Committee