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

October 31, 2018

October 30, 2018

Letter to the Secretary

Dear Mr. Secretary:

Economic activity grew at a strong pace in the third quarter, with a 3.5% annualized increase in real GDP following a very strong second quarter. Real GDP rose 3% over the past four quarters, and with a continued fiscal boost from tax and government spending legislation, growth is expected to remain fairly strong in the final quarter of 2018 and into the beginning of 2019. However, an eventual fading of the fiscal boost, the recent tightening in financial conditions, and a deceleration in the pace of global growth all point to slower growth by mid-to-late 2019.

Since the Committee last met in July, the Federal Open Market Committee (FOMC) raised the target range for the federal funds rate to 2.00%-2.25%. Overall financial conditions have tightened significantly since the last refunding, and volatility has increased in financial markets. Equity markets initially trended upwards after the last meeting, but fell nearly 10% over the last month. The 2-year Treasury yield rose slightly on net as markets came to expect a bit more tightening from the Fed, and the 10-year Treasury yield rose somewhat as well. The trade-weighted value of the dollar has appreciated by about 2% since the start of August, continuing its steady appreciation since the beginning of the year.

Consumer spending grew at a 4.0% annualized rate in the third quarter, following strong growth in the second quarter as well. The increase in spending was broad-based, with durable goods spending increasing at a 6.9% rate, non-durables goods spending increasing at a 5.2% rate, and services spending increasing at a 3.2% rate. Consumer confidence and sentiment measures remain high. Strong job growth, somewhat firmer wage growth, and a continued boost from tax cuts should contribute to continued growth in consumer spending in the upcoming quarters, although recent volatility in the equity market could weigh on sentiment and spending.

Business fixed investment decelerated sharply in the third quarter, growing at a 0.8% annualized rate after increasing at a 10.1% rate in the first half of the year. This softness reflected broad-based declines in all five components of structures investment, which fell 7.9% in total. Equipment purchases were also soft, growing at a 0.4% annualized rate. Investment in intellectual property products grew at a solid 7.9% pace, but also decelerated from prior quarters. The change in inventory investment added 2.1 percentage points to GDP growth in the third quarter, rebounding sharply from a decline the prior quarter. Surveys indicate that manufacturers remain fairly optimistic, but report increasing uncertainty about trade policy.

Residential investment fell 4.0% at an annualized rate in the third quarter, its third consecutive quarterly decline. New home sales have declined for four consecutive months, existing home sales have declined for six consecutive months, and new home inventory has grown to a level not reached since 2011. Rising interest rates have likely contributed to the slowdown in the housing sector this year, and changes to the home mortgage interest deduction included in the 2017 tax reform might also have contributed.

Net exports subtracted 1.8 percentage points from real GDP growth in the third quarter. Exports declined at a 3.5% annualized rate, while imports increased 9.1%. Goods imports have risen for five consecutive months, with some imports likely pulled forward in advance of US tariffs on imports from China. While the macroeconomic impact of tariffs appears limited so far, some companies have reported increasing materials costs from tariffs and a negative impact on earnings.

Federal spending increased at a 3.3% annualized rate in the third quarter, while state and local spending increased at a 3.2% rate. The increase in federal spending has fallen somewhat short of initial expectations over the last two quarters following the increase in federal spending caps in February, potentially suggesting a firmer pace of growth in coming quarters. The Office of Management and Budget's most recent deficit projections estimate a 5.1% of GDP deficit in fiscal year 2019.

The labor market has continued to tighten, with nonfarm payroll growth averaging 210,000 per month since the beginning of the year and the unemployment rate dropping to 3.7%, the lowest level in almost 50 years. While the September survey reported a gain of only 134,000 jobs, state-level data from the Carolinas suggest that Hurricane Florence likely reduced the pace of job gains by about 50,000 that month. Other labor market indicators, such as the quits rate, the vacancy rate, and survey reports about job availability all indicate an increasingly tight labor market, and the Federal Reserve's Beige Book continues to report labor shortages. Wage growth has been somewhat firmer in recent months but growth over the last year remains moderate, with average hourly earnings rising 2.7% and the Employment Cost Index rising 2.8%, partly reflecting low levels of productivity growth.

Consumer price inflation slowed slightly, with total personal consumption expenditures prices rising at a 1.6% rate in the third quarter and the core measure excluding food and energy rising at a 1.6% rate. However, the core measure remained at 2.0% on a year-over-year basis, in line with the FOMC's target. The FOMC currently projects a slight overshoot of the target by 2020, and most forecasters continue to expect further gradual increases in core inflation. The impact of tariffs on inflation so far appears modest, but would likely rise if further tariffs are implemented or if tariff rates increase.

In addition to the rate hike, the September FOMC meeting featured upward revisions to the Committee's projections of GDP growth in 2018 and 2019, but few other changes. The amount of projected monetary policy tightening remained unchanged, with the median FOMC participant's funds rate projections remaining at 2.4% at the end of 2018, 3.1% at the end of 2019, and 3.4% at the end of 2020. However, financial markets and survey forecasters have moved up their projections for the funds rate over the next several quarters, coming closer in line with the Committee's outlook.

The Fed's balance sheet normalization has now reached its peak pace, with the caps on monthly runoff rising to $30bn for Treasuries and $20bn for agency MBS in October. The FOMC has yet to provide clearer guidance on the ultimate size or composition of the balance sheet, although most market participants expect shrinkage to the $3-$4 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 November 2018 Quarterly Refunding Presentation to the TBAC. Total receipts were flat in FY 2018 with non-withheld up $89 billion, withheld up $23bn offset by $93bn in Corporate Tax reductions and refunds related to the Tax Cuts and Jobs Act (TCJA) of 2017. 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 $425 billion for Q1 FY 2019, with an end-of-December cash balance of $410 billion. For Q2 FY 2019, the net privately-held marketable borrowing need is estimated to be smaller at $356 billion, with a cash balance of $320 billion at the end of March. It was noted that net 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. Members discussed the expected end of debt limit suspension period on March 1st, 2019. The Committee was pleased to learn the expected cash balance on March 1, 2019 will be significantly higher than in 2017, which should reduce bill issuance volatility.

The Committee discussed the recent introduction of the 2-month bill and was pleased at the warm reception in the inaugural three auctions indicated by the robust bid to cover ratios. The Committee reiterated its support for this new maturity point and expected the new bill would continue to be well supported as the new settlement cycle takes hold.

The Committee discussed the questions which were put forth to the primary dealers, notably on the TMPG Clearing and Settlement white paper and the timing and composition of SOMA portfolio post normalization. Dealer feedback was uniformly positive on the clearing and settlement paper which highlights a number of risk management issues market participants should consider. Members encouraged further education and engagement on the risks identified in the paper. On the topic of SOMA portfolio normalization, dealers had a wide range of views on the timing of balance sheet stabilization – as early as mid-2019 to as late as end of 2021, with a median of December 2020. The Committee agreed that Treasury should closely monitor both the timing and composition of the Federal Reserve's portfolio as this could have meaningful implications for Treasury issuance decisions. Members agree that issuance decisions taken to date afford Treasury significant flexibility to accommodate potential changes in Fed policy.

The Committee noted the publication of the optimal debt issuance model via the Brookings institution website on October 10, 2018. Members were pleased that the model is in the public domain and are hopeful others will continue to adapt and improve this important work. The Committee agreed that the model is one of several factors considered when recommending issuance to Treasury. The Committee then discussed a charge on incorporating TIPS into the model. The presenting member highlighted the significant flexibility in the model which allows for variability of the inputs and correlations. Members agreed this flexibility was critical for understanding results and ensuring the model remains robust across economic environments. Overall, the model illustrates that TIPS issuance is both risk and cost reducing when added to the nominal issuance portfolio, in line with the current proportion of TIPS in the debt stock. The Committee noted that the model's conclusions are consistent with prior market feedback that intermediate TIPS maturities are preferred to long ones.

In light of the amended model, the Committee next discussed proposed changes in TIPS issuance. Given the significant increase in nominal supply through 2018, the Committee was supportive of increasing the supply of TIPS in 2019 to assist in maintaining TIPS share of debt stock. As previously noted, the Committee was broadly supportive of maintaining TIPS issuance once per month, but also of adding a second 5-year new issue TIPS to the calendar. To achieve both of these goals, members recommended replacing one of the 30-year TIPS reopenings with a new issue 5-year TIPS in October (Option 1 from the August Primary Dealer Survey) which implies a larger share of TIPS issuance in the belly. It was noted that without the second 30-year reopening, both 30-year original issue size and the remaining reopening should increase to maintain the current liquidity of long dated TIPS. The Committee was supportive of a pragmatic approach and will continue monitoring TIPS performance as the share of debt stock stabilizes.

Based on current fiscal projections, the Committee suggested increases to coupon sizes would be needed for this quarter, but expected nominal issuance increases to be limited for the remainder of FY 2019. 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. Alongside these increases in nominals, the Committee also recommended increasing TIPS issuance by $20-30 billion in 2019 to assist in maintaining the proportion of TIPS outstanding. This issuance strategy would 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. Given the uncertainty inherent in fiscal projections and the timing of SOMA portfolio normalization, Treasury will need to retain flexibility in its issuance path to respond to any changes in funding needs and accommodate historically large auction sizes.

The Committee next discussed a charge on the transition from LIBOR to SOFR, highlighting the risks of continued LIBOR dependence and the development of SOFR based products. Members discussed transition planning which is well underway with many firms establishing dedicated teams to focus on the migration. The Committee noted that while liquidity in the futures and debt issuance markets has been consistently progressing, the OTC swaps market is moving more slowly. Similarly, members noted the additional challenges with migration for the cash and consumer markets relative to the derivatives market. A number of positive industry developments were cited such as the recent FASB announcement regarding hedge accounting, but further actions were identified that would encourage SOFR market liquidity, including development of a SOFR curve and term rate, regulatory clarity on grandfathering of amended interest rate swaps, and a move to CCP calculation of PAA based on SOFR rather than Fed Funds. The Committee discussed the unique challenges for bank asset liability management, notably moving to a credit insensitive rate and the lack of an options market on non-LIBOR based indices. Further, the Committee recommended that Treasury should begin to study how SOFR linked issuance could fit into its overall debt strategy.

Respectfully,

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Beth Hammack

Chair, Treasury Borrowing Advisory Committee