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

January 30, 2019

January 29, 2019

Letter to the Secretary

Dear Mr. Secretary:

Economic activity grew at a more moderate pace since the Committee last met in October. GDP has not yet been released for the fourth quarter, and a number of economic data releases have been delayed by the closure of federal statistical agencies. The available data however suggests that real GDP growth has likely moderated in the fourth quarter from the 3.4% annual pace in the third quarter of the year. The reduced fiscal boost, tightening of financial conditions, and deceleration in the pace of global growth are likely to lead to slower growth in 2019.

Since the Committee last met, the Federal Open Market Committee (FOMC) raised the target range for the federal funds rate by 25bp to 2.25%-2.50%. Overall financial conditions have tightened a bit further since the last refunding, and volatility has continued to increase in financial markets. Equity prices fell nearly 10% in December before partially recovering to start 2019. The 2-year Treasury yield declined on net as markets came to expect less tightening from the Fed, and the 10-year Treasury yield also declined. The trade-weighted value of the dollar has depreciated by about 1% since the start of November after steadily increasing throughout most of the prior year.

Consumer spending grew at a 5.6% annualized rate in October and November, following strong growth in the third quarter of the year. The increase in spending was broad-based, with durable goods spending increasing at a 9.8% rate, non-durables goods spending increasing at an 8.0% rate, and services spending increasing at a 4.2% rate. However, consumer confidence and sentiment measures have declined, likely reflecting both the decline in equity markets as well as the government shutdown. While these factors could weigh on consumer spending, accelerating wage growth and continued strong job growth alongside lower oil prices should lead to continued strength in consumer spending in the upcoming quarters.

Business fixed investment data was mixed, with solid growth in industrial production but weaker orders and shipments of capital goods in October and November. Taken together with a sharp deceleration in the third quarter of the year, growth of business fixed investment appears to have slowed from its rapid pace in the first half of last year. Surveys also indicate that manufacturers are less optimistic, with significant declines in most manufacturing survey indexes. Residential investment appears to have continued to slow, with new home sales declining for five consecutive months and existing home sales reaching the lowest level since 2015 in December.

The trade deficit rose $0.9bn to $55.5bn in October, its fifth consecutive increase. The increase was driven by a $0.5bn rise in goods imports and a $0.4bn decline in goods exports. Trade deficit data for subsequent months have not yet been released.

Federal government spending likely grew in the fourth quarter at a rate similar to the 3.5% pace in the third quarter of last year, reflecting both the higher spending caps and increased disaster relief. The partial government shutdown reduced output slightly in the fourth quarter and more significantly in the current quarter. The Council of Economic Advisors estimates that each week of the shutdown reduced quarterly economic growth by 0.13pp, suggesting a roughly 0.1pp drag on overall GDP growth in the fourth quarter and a 0.5pp drag in the current quarter.

The labor market has continued its solid expansion, with nonfarm payroll growth averaging 220,000 per month over 2018 and 254,000 per month since the Committee last met. While the unemployment rate ticked up to 3.9% in the December household survey, this mostly reflected an increase in labor force participation. Initial jobless claims have reached their lowest level in 50 years, and other labor market indicators such as the quits rate, the vacancy rate, and survey reports about job availability all continue to indicate a tight labor market. Wage growth has firmed in recent months, with average hourly earnings rising to a cycle-high of 3.2% over the last year.

Consumer price inflation has slowed somewhat, with the Consumer Price Index (CPI) increasing at a 1.8% annualized rate in the fourth quarter and the core measure excluding food and energy rising at a 2.0% pace. Total personal consumption expenditures (PCE) prices rose at a 1.5% rate in October and November and the core measure rose at a 1.6% rate. The core measure currently stands at 1.9% on a year-over-year basis, near the FOMC's target. Most forecasters expect gradual increases in core inflation. The impact of tariffs on inflation appears modest so far, but this would likely rise if further tariffs are implemented or if tariff rates increase.

The outlook for Fed policy has significantly changed since the last refunding. In addition to the rate hike, the December FOMC meeting featured downward revisions to the amount of projected monetary policy tightening, with 25bp declines in the median FOMC participant's funds rate projections to 2.9% at the end of 2019 and 3.1% at the end 2020. Financial markets and forecasters have also moved down their projections for the funds rate over the next several quarters, reflecting recent comments by Fed officials indicating a more patient and data-dependent approach.

The Fed's balance sheet normalization has reached its peak pace, with runoff caps of $30bn per month for Treasuries and $20bn for agency MBS, although these caps will not bind in most months. The latest Federal Reserve Survey of Primary Dealers indicated that the median respondent expects balance sheet runoff to end in the first half of 2020.

In light of this financial and economic backdrop, the Committee reviewed Treasury's February 2019 Quarterly Refunding Presentation to the TBAC. Year-over-year, net receipts were up just $17 billion for Q1 of FY2019. Increases in social insurance taxes, excise taxes and customs deposits were mostly offset by declines in individual and corporate taxes. Total outlays over the same period increased 4% after calendar adjustments. Based on the Quarterly Borrowing Estimate, Treasury's Office of Fiscal Projections currently projects a net privately-held marketable borrowing need of $365 billion for Q2 FY 2019, with an end-of-March cash balance of $320 billion. For Q3 FY 2019, the net privately-held marketable borrowing need is estimated to be smaller at $83 billion, with a cash balance of $300 billion at the end of June. 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.

Members discussed the expected end of debt limit suspension period on March 1st, 2019. TBAC members agreed with former Chair Matt Zames' statement that, "The debt limit should not be seen as a budget tool. It is simply a limit on Treasury's ability to borrow to pay obligations that have already been incurred by Congress during the budget process." In addition, the Committee noted sensitivity from one ratings agency due to the recent government closure. Though current uncertainty on the duration of extraordinary measures is high due to data availability, given the expected cash balance on March 1, 2019 will be significantly higher than in 2017, preliminary street estimates expect exhaustion of those measures in the third quarter of 2019.

The Committee discussed the recent electronic inter-dealer broker market outage. Given the timing of the outage on a Friday afternoon, the impact on liquidity was muted. It was noted that had this happened in the morning, around an auction or key economic release, the impact would likely have been far greater.

Treasury reviewed the responses to the Primary dealer questionnaire. Dealers were supportive of an additional auction slot around 10am. Members agreed that the earlier timing would be beneficial for busy weeks as long as it did not conflict with data releases. The Committee had no concerns that the earlier timing would limit regional participation and could in fact increase European participation.

Treasury also presented some information about publicly available data on foreign participation in primary and secondary Treasury markets. There are notable differences in how the data is calculated and presented across sources. However, the Committee agreed that while foreign holdings have been reasonably static over the past several years in notional terms, given the meaningful increase in Treasury issuance, the share of holdings by foreigners has declined. Members agreed this was most likely a technical result of debt outstandings growing faster than foreign reserves.

Based on current fiscal projections, and in line with the November recommendations, the Committee suggested no change to coupon issue sizes for this quarter, and expected little or no change to nominal issuance for the remainder of FY 2019. However, 2020 could be more challenging depending on timing of SOMA portfolio normalization. The Committee recommended increasing TIPS issuance by 2bn this quarter to be split as follows: 1bn additional for the February 30-year new issue to 8bn, no change to the March 10- year reopening at 11bn and 1bn for the April 5-year new issue to 17bn. This issuance strategy would be broadly consistent with TBAC's prior recommendation that TIPS issuance increase by 20-30bn in 2019 (accounting for the new issue 5- year TIPS in October) and would allow between one-quarter and one-third of the financing gap to be met with T-bill issuance. By increasing TIPS sizes gradually, Treasury will be able to assess market demand for the increased supply while maintaining appropriate liquidity in each issue.

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 to accommodate historically large auction sizes. Members agree that decisions taken to date afford Treasury significant flexibility to respond to potential changes in Fed policy including potential long run maturity composition changes in the SOMA Treasury portfolio, as noted in the December FOMC minutes.

The Committee next discussed a charge on potential innovations in Treasury products and tools. The presenting member estimated borrowing needs to exceed $12 Trillion without factoring in the possibility of a recession which would pose a unique challenge for Treasury over the coming decade. Additionally, given stagnation in international reserves, there is likely an increased need for this debt to be financed domestically. This blue sky discussion, in the context of the optimal debt model, focused on the need to expand demand, while preserving the key tenets of regular and predictable issuance at the lowest cost to taxpayers over time. A number of possible new products were reviewed including CPI subcomponent linked TIPS, ultra-long dated issuance, zero-coupon issuances and an expanded FRN program. Any of these products would require extensive further review before formal recommendations could be reached. Independent of the broader innovation questions, the potential for SOFR linked FRNs will likely merit further study as the SOFR linked debt and derivative markets continue to develop.

Next, the Committee reviewed a charge on the when-issued (WI) market and any recommended changes. Despite increasing frequency and size of auctions, WI trading volumes have likely decreased due to reduced volatility and reduced dealer award shares. Analysis was based on a small number of individual participant’s data given the lack of publicly available WI trading data. It was also noted that participants may not be submitting data to FINRA in a consistent manner. Regardless, the length of the WI period appears sufficient to encourage solid price formation and market liquidity both ahead of and at the time of auction.

Respectfully,

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Beth Hammack

Chair, Treasury Borrowing Advisory Committee