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

May 1, 2019

April 30, 2019

Letter to the Secretary

Dear Mr. Secretary:

Economic activity grew at a strong pace in the first quarter, with a 3.2% annualized increase in real GDP despite an estimated 0.3pp drag from the government shutdown. The strength resulted in part from rapid inventory accumulation and a large decline in imports, factors that are likely to reverse, and domestic final sales grew at a slower 1.4% pace. Looking ahead, both the growth drag from the large tightening in financial conditions last year and the growth boost from tax and government spending legislation are likely to fade. Growth is likely to slow over the remainder of 2019 from the 3.2% pace seen over the last four quarters, but is expected to remain somewhat above estimates of the economy's longer-run potential.

Since the Committee last met in January, the Federal Open Market Committee (FOMC) held the target range for the federal funds rate at 2.25%-2.50%. Overall financial conditions have eased significantly since the last refunding. Equity prices have now fully reversed their large decline in the fourth quarter of last year, with the S&P 500 rising roughly 17% so far this year. The 2-year Treasury yield declined further as the Fed indicated that rate hikes are unlikely in the near term, and the 10-year Treasury yield declined as well. The trade-weighted value of the dollar has been little changed since the last refunding.

Consumer spending grew at a 1.2% annualized rate in the first quarter, considerably softer than in prior quarters. Durable goods spending fell at a 5.3% rate, non-durables goods spending rose at a 1.7% rate, and services spending rose at a 2.0% rate. The monthly household spending data have shown stronger momentum, however, and both consumer confidence and consumer sentiment have improved somewhat since the last refunding. Strong job growth, firm wage growth, and the significant rebound in equity markets are likely to boost consumer spending in the coming quarters.

Business fixed investment decelerated sharply in the first quarter, growing at a 2.7% annualized rate after rising 7% over the prior four quarters. Structures investment declined at a 0.8% annualized rate and equipment purchases grew at just a 0.2% annualized rate. Investment in intellectual property products grew at a solid 8.6% pace. The change in inventory investment added 0.7 percentage points to GDP growth in the first quarter, but now stands at a high level and is likely to be a drag in coming quarters. Surveys indicate that manufacturers remain fairly optimistic.

Residential investment fell at a 2.8% annualized rate in the first quarter. Rising interest rates likely contributed to the weakness in the housing sector last year, but the decline in mortgage rates this year should provide a boost to housing activity in the remainder of 2019. Some signs of a housing rebound have emerged. New home sales have increased for three consecutive months and surveys of home builders have indicated increased optimism, although housing starts and permits remain somewhat low.

Net exports added 1 percentage point to real GDP growth in the first quarter. Exports rose at a 3.7% annualized rate, while imports fell at a 3.7% rate. The Federal Reserve's Beige Book noted that some contacts reported that trade and tariffs were weighing on their outlook, while others reported that recent progress on trade deals had improved their outlook.

Federal spending declined at a 0.1% annualized rate in the first quarter, reflecting the impact of the government shutdown. The Bureau of Economic Analysis estimates that the shutdown subtracted 0.3pp from GDP growth in the first quarter and 0.1pp from GDP growth in the fourth quarter of 2018. This should lead to a mechanical rebound in government spending in the second quarter, boosting GDP growth by about 0.4pp. State and local spending increased at a 3.9% rate. The Office of Management and Budget's most recent deficit projections estimate a 5.1% deficit in fiscal year 2019.

The labor market has remained strong, with nonfarm payroll growth averaging 180,000 per month since the beginning of the year. The unemployment rate declined to 3.8%, just above the cycle low of 3.7% reached last fall and close to the lowest level in about 50 years. Labor force participation declined to 63.0% in March, but remains in the upper end of the range over the last five years. Other labor market indicators, such as the quits rate, jobless claims, and anecdotes from the Federal Reserve's Beige Book all point to a healthy labor market, although job openings have declined recently. Average hourly earnings rose at a 3.2% pace over the last year.

Consumer price inflation has slowed recently. The total personal consumption expenditures price index rose at a 0.6% annualized rate in the first quarter and the core measure excluding food and energy rose at a 1.3% rate. The core measure rose 1.7% over the last four quarters, somewhat below the FOMC's 2% target. Several Fed officials have expressed concern that inflation persistently below the Fed's 2% target could lead to a gradual decline in inflation expectations.

In addition to keeping rates on hold, FOMC participants made downward revisions to their projections of monetary policy tightening at the March meeting. The median FOMC participant now projects no change in the funds rate through the end of 2019 and only one in 2020. Financial markets and survey forecasters have also moved down their projections for the funds rate over the next year.

The FOMC also provided additional guidance on the Fed's balance sheet normalization at the March meeting. The Committee announced that the caps for monthly runoff of Treasuries would decline from $30bn to $15bn from May to September and that the shrinkage of the balance sheet would conclude after September, with maturing mortgage-backed securities reinvested in Treasuries starting in October. Based on most market projections, the balance sheet will likely stand in the $3.7-$3.8 trillion range in September. Although the balance sheet will likely remain steady for some time, bank reserve balances will shrink gradually due to the growth of non-reserve liabilities such as currency in circulation, until the FOMC eventually decides to begin growing the balance sheet again.

In light of this financial and economic backdrop, the Committee reviewed Treasury's May 2019 Quarterly Refunding Presentation to the TBAC. Year-over-year, net receipts were up just $10 billion for Q2 of FY2019. Increases in customs duties and excise taxes were mostly offset by declines in Federal Reserve earnings due to higher short term interest rates. Total outlays over the same period increased 5% 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 $30 billion for Q3 FY 2019, with an end-of-June cash balance of $270 billion. For Q4 FY 2019, the net privately-held marketable borrowing need is estimated to be larger at $160 billion, with a cash balance of $85 billion at the end of September, owing to debt limit considerations. 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 noted that Treasury was already undertaking extraordinary measures as the debt limit suspension period ended on March 1st, 2019. TBAC members urged Treasury to work with Congress to resolve the debt ceiling issue with all due haste, as the debt limit should not be viewed as either a political or budget tool. Additionally, members expressed concern that the projected cash balance at the end of September would be so far below TBAC's recommended prudent level of 5 days of liquidity subject to a $150 billion minimum. Though uncertainty on the duration of extraordinary measures is high due to the inherent uncertainty in cash flow projections, preliminary street estimates expect exhaustion of those measures in the third or fourth quarter of 2019.

Treasury reviewed the responses to the Primary dealer questionnaire. On average, dealers expected that the Federal Reserve would begin growing their balance sheet again in Q3 of 2020 due to growth in currency and bank reserves, though some projected it to be as late as 2025. As well, dealers expected the long run composition to return to all Treasuries, though there was disagreement on maturity composition of that all Treasury balance sheet. A majority expected the Fed to own securities in line with Treasury's outstanding stock, though a substantial minority expected the Fed to shorten the duration of their portfolio to provide increased flexibility in the advent of a future recession. It was noted that both of these options, matching Treasury's outstanding portfolio or concentrating on short end holdings, would be a shortening of the duration of the SOMA portfolio.

Dealers also commented on their experience with TRACE reporting, and ways to enhance the TRACE data. Many noted that given the significant volume of transactions, there were initial difficulties in reporting, but those had largely been resolved. Most also noted that reducing the time delay on reporting from end of day to closer to real time would not be operationally burdensome. However, including execution method was viewed as beneficial from a transparency perspective but could require meaningful technology investment.

Based on current fiscal projections, and in line with the February 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. The Committee acknowledged that maintaining current issue sizes would require a reduction in bills issuance over the near term, and reduce the proportion of bills below TBAC's prior recommendation of 25-33% of new issuance. The Committee noted that the 25-33% of issuance target was a longer-term average goal and that Treasury should respond to transient changes in borrowing needs, as it has historically, by changing bill auctions sizes as necessary. The Committee agreed that maintaining current coupon sizes was most consistent with Treasury's regular and predictable issuance strategy to provide lowest cost to the taxpayers over time, particularly as 2020 and especially 2021 could require further coupon increases given current fiscal projections and uncertainty surrounding SOMA portfolio composition.

The Committee also recommended increasing TIPS issuance by $2bn this fiscal quarter to be split as follows: no change to the May 10-year reopening at $11bn, a $1bn increase in the June 5-year reopening to $15bn and $1bn for the July 10-year new issue to $14bn. 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). By increasing TIPS sizes gradually, Treasury will continue to assess market demand for the increased supply while maintaining appropriate liquidity in each issue. In this light, Treasury shared a presentation reviewing TIPS issuance, trading volumes and investor trends.

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 agreed 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 March FOMC minutes.

The Committee next discussed a charge estimating pricing for a hypothetical Treasury SOFR FRN. The presenting member reviewed rapid growth in the markets for SOFR indexed futures, swaps, and cash securities. The member noted the significant issuance by GSEs in SOFR-linked FRNs ranging from 6-months to 2-years. Based on current market data, using both forward rates and GSE issuance as a baseline, the committee expected Treasury could price SOFR FRNs reasonably in line with the existing T-Bill FRN pricing. The committee further noted that introduction of a Treasury SOFR FRN could be a significant step forward in boosting the liquidity of the SOFR market and could help expedite the transition away from LIBOR. The committee unanimously agreed that Treasury should play a prominent role in developing the SOFR market by considering SOFR-linked FRN issuance, particularly if it does not come at an increased cost to taxpayers. However, the committee noted that Treasury issuance of a SOFR-linked FRN was unlikely to be imminent given the large number of questions yet to be examined including demand for an overnight indexed security, operational issues, and design choices. In conclusion, the committee agreed that SOFR-linked FRNs merited further study as the SOFR-linked debt and derivative markets continue to develop.

Next, the Committee considered a charge reviewing the optimal funding mix between fixed and floating rate securities. Using the recently developed Debt Management Model, members defined floating rate issuance as including T-Bills as well as FRNs, given their similar impact in the model on variability to debt service. The members drew a distinction, however, between the interest rate risk and rollover risk of Bills and FRNs. While bills have high amounts of both interest rate and rollover risk, FRNs (depending on the maturity) can add to interest rate risk without increasing rollover risk.

The committee noted that the US has recently increased the proportion of variable rate debt outstanding, though that proportion is still below the historical average. As well, the US has the highest proportion of variable rate debt of any developed market country. Though the model's optimal issuance varies over time, given the current low term premium and low front end rates, the model generally favors intermediate issuance. However, a return to a more normalized term premium environment would encourage the model to suggest increased floating rate issuance. The committee again agreed that WAM is an imperfect metric and encouraged Treasury to focus on other metrics like rollover risk, which would favor intermediate issuance.

Respectfully,

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Beth Hammack

Chair, Treasury Borrowing Advisory Committee