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

July 31, 2019

July 30, 2019

Letter to the Secretary

Dear Mr. Secretary:

Economic activity grew at a moderate pace in the second quarter, with a 2.1% annualized increase in real GDP. Real GDP rose 2.3% over the past four quarters, somewhat above estimates of the economy's longer run potential. Going forward, the easing in financial conditions since the start of this year will likely provide a boost to growth, while the slowdown in global growth and further fading of the fiscal boost will likely be headwinds in the remainder of the year.

Since the Committee last met in April, the Federal Open Market Committee (FOMC) held the target range for the federal funds rate at 2.25%-2.50%, but Fed officials have strongly indicated that a rate cut is likely at the upcoming July meeting. Overall financial conditions have eased further since the last refunding. Equity prices have more than fully reversed their May decline over the last two months, with the S&P 500 now up roughly 20% so far this year to new highs. The 2-year Treasury yield declined further as the Fed indicated that rate cuts are likely in the near term, and the 10-year Treasury yield declined as well. The trade-weighted value of the dollar has changed little on net since the last refunding.

Consumer spending grew at a 4.3% annualized rate in the second quarter, considerably stronger than in prior quarters and the fastest pace since 2017. The strength was broad-based, with durable goods spending rising at a 12.9% rate, non-durables goods spending increasing at a 6.0% rate, and services spending increasing at a 2.5% rate. The monthly household spending data have shown strong momentum, and consumer confidence and consumer sentiment remain at high levels. Solid job growth and the continued increase in equity prices are likely to provide further momentum for consumer spending in the coming quarters.

Business fixed investment slowed in the second quarter, declining at a 0.6% annualized rate. Structures investment fell sharply at a 10.6% annualized rate and equipment purchases grew at a soft 0.7% annualized rate, weighed down by the Boeing 737-MAX grounding. Investment in intellectual property products decelerated to a 4.7% annualized pace after rising at an 11.3% pace over the last two quarters. The change in inventory investment subtracted 0.9 percentage points from GDP growth in the second quarter. Regional manufacturing surveys so far in July have been mixed, and have overall declined over the last several months.

Residential investment fell at a 1.5% annualized rate in the second quarter, its sixth consecutive quarterly decline. New home sales, housing starts, and permits remain somewhat low, although surveys of home builders have indicated increased optimism since the start of the year. 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 going forward.

Net exports subtracted 0.7 percentage points from real GDP growth in the second quarter, as real exports declined sharply at a 5.2% annualized rate, while imports were little changed from the prior quarter. The Federal Reserve's Beige Book noted that contacts continued to report that uncertainty surrounding trade and tariffs is weighing on the outlook.

Federal spending increased at a 7.9% annualized rate in the second quarter, in part reflecting a bounce-back from the government shutdown that depressed spending in Q1, an effect that contributed about 0.4 percentage points to Q2 GDP growth. State and local spending increased at a 3.2% rate. The Office of Management and Budget's most recent deficit projections estimate a 4.7% budget deficit in fiscal year 2019. The White House and congressional leadership recently announced an agreement to suspend the debt limit through July 2021 and raise spending caps, with the bill still subject to approval from the Senate.

The labor market has remained solid, with nonfarm payroll growth averaging 172,000 per month since the beginning of the year. The unemployment rate has edged down to 3.7% since the last meeting, close to the lowest level in the last 50 years, and the labor force participation rate remained at 63.0% in June, near the upper end of the range over the last five years. Other labor market indicators such as the quits rate, jobless claims, job openings, and anecdotes from the Federal Reserve's Beige Book all point to a strong labor market. Average hourly earnings rose at a 3.1% pace over the last year, a slight deceleration relative to the first quarter of the year.

Consumer price inflation has remained somewhat soft. While the total personal consumption expenditures price index rose at a 2.3% annualized rate in the second quarter, the core measure excluding food and energy rose at only a 1.8% rate. The core measure rose 1.5% over the last four quarters. Many Fed officials have expressed increasing concern about inflation remaining below the 2% target and low inflation expectations, with several officials citing soft inflation as a key reason for lowering the funds rate.

FOMC participants made significant downward revisions to their interest rate projections at the June meeting. Roughly half of FOMC participants thought it would be appropriate to lower the funds rate in 2019, and the post-meeting statement emphasized increased uncertainties about the outlook and muted inflation pressures. Fed communication since the June meeting has further reinforced the likelihood of a cut in the funds rate. Financial markets and survey forecasters have moved down their projections for the funds rate over the next year, with a cut of at least 25bp at the upcoming meeting seen as a near certainty.

The FOMC has also indicated that an early end to balance sheet runoff at the upcoming July meeting is likely, with Fed officials strongly suggesting runoff will conclude should the FOMC deliver a rate cut. The balance sheet will thus likely remain steady at roughly $3.8bn until it begins growing again at a future date, although bank reserve balances will continue to shrink gradually due to the growth of non-reserve liabilities such as currency in circulation.

In light of this financial and economic backdrop, the Committee reviewed Treasury's August 2019 Quarterly Refunding Presentation to the TBAC. FY 2019 year-to-date receipts were $68 billion (3%) higher than the comparable period in 2018. Increases in customs duties (due to new tariffs) and withheld income and FICA taxes, as well as lower refunds, were the largest drivers partially offset by a decline in Federal Reserve earnings due to higher short term interest rates and lower corporate taxes. Total outlays over the same period were $205 billion higher, an increase of 7% 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 $433 billion for Q4 FY 2019, with an end-of-September cash balance of $350 billion, assuming the proposed debt limit suspension bill passes the Senate and is signed by the

President. Treasury noted that this borrowing estimate implies about $160 billion of net bill issuance over the remainder of the quarter, or roughly half as large as the $330 billion increase in bills outstanding in March 2018 over a similar time frame.

For Q1 FY 2020, the net privately-held marketable borrowing need is estimated to be larger at $381 billion, with a cash balance of $410 billion at the end of December. It was noted that privately-held marketable borrowing excludes rollovers of Treasury securities held in the Federal Reserve's System Open Market Account (SOMA), but includes financing required due to SOMA redemptions. The Committee also reviewed the path of expected growth of the SOMA portfolio assuming SOMA redemptions cease in September as originally planned. It was noted that if the SOMA redemptions ended shortly after the upcoming July FOMC meeting, that would reduce FY 2019 financing needs by approximately $28 billion.

Members were pleased that you were able to negotiate a debt limit suspension bill with Congress well in advance of the deadline and are optimistic that the bill will become law in short order. It was noted, however, that this would mark the 7th debt limit suspension in less than 7 years. As debt limit suspensions expire, Treasury has been required to employ extraordinary measures - increasing market volatility, operational risk and ultimately taxpayer cost. The Committee strongly believes that discussions on total borrowing are more appropriately considered when making appropriations rather than when funding previously approved appropriations. The Committee unanimously urged Congress to consider a repeal of the debt limit well ahead of the proposed 2021 expiration of the suspension.

Treasury reviewed the responses to the primary dealer questionnaire. On balance, dealers expected that the Bill supply would increase $178 billion over the following 8 weeks once debt limit concerns were resolved. Of note, dealers anticipated market capacity of $210 billion over that same period without causing significant price distortions in the front end of the curve. The Committee discussed at length the speed with which Treasury should replenish the cash balance. The Committee generally agreed that Treasury should increase issuance at a moderate pace, taking into account seasonal factors, potential market impact of rapid Bill issuance, and operational risk of running below the recommended target cash balance for a prolonged period.

Based on current fiscal projections, and in line with the May recommendations, the Committee suggested no change to coupon issue sizes for this quarter, and expected little or no change to nominal issuance for much of FY 2020, based on current forecasts. 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, but noted that 2021 could require further coupon increases given current fiscal projections despite a likely return to SOMA portfolio growth. The Committee briefly discussed recent cheapening of Treasury securities relative to swaps and agreed levels warranted close monitoring.

The Committee recommended increasing TIPS issuance sizes for Q4 of FY 2019 given the pre-announced change in the auction schedule. Specifically, the Committee recommended increasing the August 30- year reopening by $2bn to $7bn, increasing the September 10- year reopening by $1bn to $12bn, and a new issue size of $17bn for the inaugural new issue 5- year TIPS in October. This issuance strategy would be broadly consistent with TBAC's prior recommendation that TIPS issuance increase by $20-30bn in 2019, and maintain TIPS share of overall debt. Given the significant but anticipated change in the TIPS issuance pattern this quarter, the Committee encouraged Treasury to continue to closely monitor market demand and liquidity for TIPS.

Given the uncertainty inherent in fiscal projections and Fed balance sheet policy, 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 fiscal projections or Fed policy including potential composition changes in the SOMA portfolio.

Primary dealers also commented on the potential costs and benefits of the official sector encouraging broader use of central clearing for Treasury securities as suggested by the recent TMPG white paper on Treasury clearing and settlement risks. On the benefits side, transparency and centralized risk should allow for participants to better understand their exposures, may reduce un-margined credit risk and may minimize market disruptions due to a participant default. On the costs side, centralized clearing would increase concentration risk to a single counterparty and may increase transactions costs. The Committee was supportive of Treasury continuing to study the potential for increased usage of central clearing of Treasuries.

The Committee next reviewed a charge comparing a hypothetical introduction of 1- year SOFR FRN to a 1- year T-Bill FRN, and an increase in 1- year T-Bill issuances. 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 or perhaps better than the existing T-Bill

FRN pricing. The presenter suggested that demand for a 1- year FRN would be higher than for increased 1- year T-Bill auctions given 2a7 fund WAM considerations. Further, the presenter highlighted benefits of a 1-year SOFR FRN relative to a 1- year T-Bill FRN, notably larger demand for a daily resetting floater and diversification by using an index that is not self-referential. Several areas were recommended for further study in consultation with market participants including technical design of a possible SOFR FRN, ongoing demand for the 2- year FRN, sizing of potential 1- or 2- year issuance, and standardization of indices across FRNs, amongst others.

The Committee again agreed that introduction of a Treasury SOFR FRN would be a significant step forward in boosting the liquidity of the SOFR market and could help expedite the overall market 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. The Committee noted that Treasury issuance of a SOFR-linked FRN was unlikely to be imminent given operational issues and design choices.

Respectfully,

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Beth Hammack
Chair, Treasury Borrowing Advisory Committee

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Daniel Dufresne
Vice Chair, Treasury Borrowing Advisory Committee