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

October 30, 2019

October 29, 2019

Letter to the Secretary

Dear Mr. Secretary:

Economic activity grew at a moderate pace since the Committee last met in July. GDP has not yet been released for the third quarter, but the available data suggest that real GDP growth has likely slowed slightly in the third quarter from the 2.0% annualized pace in the second quarter of the year. The further fading of the fiscal boost and the continued slowdown in global growth will likely remain headwinds going into 2020, while the easing in financial conditions since the start of the year should provide a boost to growth.

Since the Committee last met, the Federal Open Market Committee (FOMC) lowered the target range for the federal funds rate by 50bp to 1.75%-2.0%. Overall financial conditions have remained roughly neutral on net since the Committee last met. Equity prices declined nearly 5% in early August but have since recovered to near record highs. The 2-year Treasury yield declined on net as markets continued to expect further easing from the Fed, and the 10-year Treasury yield also declined. The trade-weighted dollar has appreciated by about 1% since the start of August.

Consumer spending grew at a 2.2% annualized rate in July and August, following strong growth in the second quarter of the year. The increase in spending was concentrated in the goods sector, with durable goods spending increasing at an 11.2% rate, non-durables goods spending increasing at a 4.3% rate, and services spending increasing at a 0.3% rate. Consumer confidence and sentiment measures have declined slightly on net in the third quarter of the year but remain at high levels. Continued solid job growth and high equity prices are likely to provide further momentum for consumer spending in the coming quarters.

Business fixed investment data continued to soften, with weak growth in orders and shipments of capital goods in July and August. Following a small decline in the second quarter of the year, business fixed investment appears to be contracting again in Q3. On the structures side the weakness has been broad-based, while on the equipment side the weakness has been more narrowly concentrated in the aircraft category, driven by the grounding of the Boeing 737 MAX. Surveys also indicate that manufacturers are less optimistic, with significant declines in most manufacturing survey indexes.

Residential investment appears to have picked up, with new home sales, housing starts, and permits all increasing thus far in the third quarter, following a decline in residential investment in the second quarter of the year. Surveys of home builders have indicated increased optimism since the start of the year, and the significant decline in mortgage rates this year should provide a boost to housing activity going forward.

The Office of Management and Budget's most recent deficit projections estimate a $1.0tn federal deficit in fiscal year 2019, or 4.7% of GDP. The trade deficit declined by $1.5bn in July and increased by $0.9bn to $54.9bn in August, with the recent increase driven by a $1.2bn rise in goods imports. The Federal Reserve's Beige Book continued to note that contacts reported that uncertainty surrounding trade and tariffs was weighing on the outlook.

The labor market has remained solid, with nonfarm payroll growth averaging 157,000 per month over the last three months. The unemployment rate has declined further to a 50-year low of 3.5%, and the labor force participation rate remained at its 6-year high of 63.2% in September. Other labor market indicators such as the quits rate, jobless claims, and anecdotes from the Federal Reserve's Beige Book all continue to point to a strong labor market. Average hourly earnings rose at a 2.9% pace over the last year, decelerating since the Committee last met.

Consumer price inflation has picked up somewhat, with the Consumer Price Index (CPI) increasing at a 1.8% annualized rate in the third quarter and the core measure excluding food and energy rising at a 3.0% pace. Total personal consumption expenditures (PCE) prices rose at a 1.6% rate in July and August and the core measure rose at a 2.1% rate. The core measure currently stands at 1.8% on a year-over-year basis and has gradually risen toward the FOMC's target in recent months.

In addition to the two rate cuts, FOMC participants made further downward revisions to their interest rate projections at the September meeting. Seven of seventeen FOMC participants thought that an additional rate cut in 2019 was likely to be appropriate, while the remaining

participants either thought that the September rate cut was unnecessary or that the September cut was appropriate but further rate cuts were unlikely to be necessary. Fed communication since the September meeting has further increased the likelihood of another cut in the funds rate, and financial markets and survey forecasts see a cut of 25bp at the upcoming October meeting as a near certainty.

Money market interest rates rose suddenly in mid-September, with repo rates peaking at 10% and the fed funds rate settling 5bp above its target range for one day. The proximate cause of the jump was a sharp swing in Treasury cash balances, driven by tax payments and debt settlement, which translated to a large drop in reserve balances. The deeper cause was the gradual drain of reserves caused by the shrinking of the Fed's balance sheet. Intermediation bottlenecks related to regulatory capital requirements also likely contributed by impeding lending even at elevated interest rates.

These events indicated that the minimum necessary level of reserves is higher than implied by the responses to the Fed's Senior Financial Officer Survey. The Fed has therefore responded with both temporary and permanent open market operations. The latter aim to boost reserves by purchasing bills at least through the start of Q2, at an initial pace of approximately $60 billion per month. While these actions should help to control money market rates in the near term and eventually return reserves to an appropriate level, they could prove insufficient to prevent year-end funding stress similar to that seen during the fourth quarter in recent years. After the boost to reserve levels is complete, the Fed will likely grow its balance sheet at a more moderate pace to accommodate natural growth in demand for its liabilities over time.

In light of this financial and economic backdrop, the Committee reviewed Treasury's November 2019 Quarterly Refunding Presentation to the TBAC. FY 2019 receipts were $133 billion (4%) higher than 2018. Increases in customs duties (due to new tariffs), withheld income and FICA taxes, as well as lower refunds, were the largest drivers. This was partially offset by a decline in Federal Reserve earnings due to higher short-term interest rates. Total outlays over the same period were $291 billion higher, an increase of 7%, driven by Social Security outlays, Defense spending, Medicare and Medicaid costs, interest cost, and education expenditures. This was partially offset by a decline in HUD outlays. Based on the Quarterly Borrowing Estimate, Treasury's Office of Fiscal Projections currently projects a net privately-held marketable borrowing need of $352 billion for Q1 FY 2020, with an end-of-December cash balance of $410 billion.

For Q2 FY 2020, the net privately-held marketable borrowing need is estimated to be larger at $389 billion, with a cash balance of $400 billion at the end of March. It was noted that privately-held net marketable borrowing excludes rollovers of Treasury securities and Treasury Bills held in the Federal Reserve's System Open Market Account (SOMA), but includes financing required from the private sector due to SOMA redemptions. Secondary market purchases of Treasury securities by SOMA do not directly change net privately-held marketable borrowing, but when they mature would increase the amount of cash raised for a given privately-held auction size by increasing the SOMA "add-on" amount.

Based on current fiscal projections, and coupled with the Federal Reserve's recently announced T-Bill purchases, it is possible that scarcity could develop in the T-Bill market if Treasury maintains its current coupon issuance sizes. Barring any change in issuance pattern, the Committee would expect to see a greater divergence in money market rates across T-Bills, CP, Fed Funds, SOFR and term repo rates. Additionally, year-end financing rates are expected to be volatile again owing to regulatory capital constraints primarily on the global systemically important banks (GSIBs).

The Committee discussed at length the benefits and concerns of altering coupon issuance in light of recent Fed actions, including review of a scenario with 2- and 3-year issue sizes dramatically smaller to maintain the size of privately-held T-Bills. While smooth market functioning and adequate supply of T-Bills are vital, given current fiscal projections of increased borrowing needs in 2021 and 2022, and in keeping with Treasury's regular and predictable issuance strategy to provide the lowest cost to the taxpayers over time, the Committee recommended keeping coupon issuance sizes unchanged for this quarter. Based on current fiscal projections, and in line with the August recommendations, the Committee expected little or no change to nominal issuance for much of FY 2020, but noted that FY 2021 could require further coupon increases. Finally, the Committee recommended continued close monitoring of developments in Treasury and Treasury funding markets, given expected changes in size and composition of the SOMA portfolio. We discussed the Committee's prior recommendation that between one quarter and one third of the financing gap be met with T-Bill issuance. While this quarter's issuance will fall meaningfully below that target, (17%) the group expected Q2 FY2020 to be meaningfully above the target (39%). All agreed that the guidance was intended as a medium term goal to help increase the share of T-Bills outstanding over time, rather than a quarter-by-quarter directive. Given that T-Bills now represent 14.5% of debt outstanding and FRNs a further 2.5%, the Committee suggested future review on the appropriate share of

variable rate debt taking into consideration projected interest expense, a potential SOFR FRN, and overall market functioning.

Market demand for TIPS remained healthy amidst the recent change in issuance pattern, including the very well received inaugural October issuance of 5- year TIPS. The Committee recommended leaving TIPS issue sizes unchanged given the $21 billion increase in TIPS supply for calendar year 2019, which was within the recommended $20-30 billion increase for the year.

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 further changes in the SOMA portfolio size and composition. The Committee continued its evaluation of new products by reviewing a charge on expected demand for a 20-year Treasury. The presenter expected such an issue would be met with robust demand from corporate pensions, insurance companies and others, but would find less demand from foreign buyers at auction. Overall, the Committee expected meaningful demand for a 20-year point in the curve across the broad investor base. Further, a new point on the curve could be a cost effective way to help meet projected increases in borrowing in 2021 and 2022.

The committee debated expected pricing at length and whether a 20-year would create a hump in the yield curve as was the case in the 1980s when 20-years were last issued. On net, we agreed a 20-year point could be a positive addition to Treasury's issuance tool-kit, but more review was warranted on expected pricing, sizing, and sustainability of demand before drawing a final conclusion.

Respectfully,

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Beth Hammack Chair,
Treasury Borrowing Advisory Committee

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Daniel Dufresne Vice Chair,
Treasury Borrowing Advisory Committee