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

February 5, 2020

February 4, 2020

Letter to the Secretary

Dear Mr. Secretary:

Economic activity grew at a moderate pace in the fourth 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 significant easing in financial conditions over the course of 2019 will likely provide a boost to growth, while a further fading of the fiscal boost will likely be a headwind in the remainder of the year. While global growth decelerated considerably in 2019, some signs of a rebound have emerged, although the ongoing coronavirus outbreak presents downside risk to the near-term global growth outlook.

Since the Committee last met, the Federal Open Market Committee (FOMC) lowered the target range for the federal funds rate by 25bp to 1.50%-1.75%. Overall financial conditions have eased further since the last refunding. Equity prices increased nearly 6% on net, despite declining in recent weeks following news of the coronavirus outbreak. The 2-year Treasury yield and the 10-year Treasury yield both declined on net. The trade-weighted dollar remained roughly flat since the Committee last met.

Consumer spending grew at a 1.8% annualized rate in the fourth quarter, decelerating from the 2.9% pace in the first three quarters of 2019. Services spending increased at a 2% rate, while durable goods spending increased at a 2.1% rate and non-durables spending increased at a 0.8% rate. Consumer confidence and consumer sentiment remain at high levels, and continued solid job growth and the increase in equity prices are likely to provide a boost to consumer spending in the coming quarters.

Business fixed investment continued to soften, declining for the third consecutive quarter. Structures investment fell sharply at a 10.1% annualized rate, and equipment investment declined at a 2.9% rate. Investment in intellectual property products accelerated modestly to a 5.9% pace, while the change in inventory investment subtracted 1.1 percentage points from GDP growth in the fourth quarter. Regional manufacturing surveys thus far in January have showed some signs of a pickup, following sizable declines in most manufacturing surveys for much of 2019.

Residential investment increased at a 5.8% annualized rate in the fourth quarter, its second consecutive quarterly increase following six consecutive quarterly declines. New home sales, housing starts, and permits have all picked up over the last two quarters, and surveys of homebuilders have indicated a high level of optimism in recent months. Mortgage rates declined significantly over the last year, which should provide a continued boost to housing activity.

Net exports contributed 1.5pp to real GDP growth in the fourth quarter, as real exports increased at a 1.4% annualized rate while real imports fell sharply at an 8.7% annualized rate, the fastest pace of decline since the previous recession. The Federal Reserve's Beige Book indicated that tariffs and trade uncertainty continued to weigh on some businesses, although some contacts reported a more optimistic trade outlook following recent trade negotiations. Federal spending increased at a 3.6% annualized rate in the fourth quarter, while state and local spending increased at a 2.2% rate. The Office of Management and Budget's most recent deficit projections estimate a 4.7% deficit in fiscal year 2020.

The labor market has remained solid, with nonfarm payroll growth averaging 184,000 per month over the last three months. The unemployment rate remained at a 50-year low of 3.5%, while the broader underemployment rate dropped to 6.7%, the lowest on record. The labor force participation rate remained at a 6-year high of 63.2%, and the employment-to-population ratio remained at its cycle-high of 61.0%. Other labor market indicators such as the quits rate, jobless claims, job openings, 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 in the last several months.

Consumer price inflation has remained fairly soft. The total personal consumption expenditures price index rose at a 1.6% annualized rate in the fourth quarter, and the core measure excluding food and energy rose at only a 1.3% rate. The core measure rose 1.6% over the last four quarters. Many Fed officials have expressed continued concern about inflation remaining below the 2% target and low inflation expectations.

In addition to the rate cut at the October meeting, FOMC participants made changes to their interest rate projections at the December meeting. Most FOMC participants projected that no rate change this year would likely be appropriate, while several participants projected that one rate hike would be appropriate. Recent Fed communication and the January FOMC meeting have further reinforced the likelihood that the funds rate will remain on hold barring a material change to the outlook.

The reserve management operations that the Fed undertook in response to the September funding market volatility significantly boosted the level of reserves into year-end. Despite concern among market participants that year-end would bring another bout of volatility, overnight rates were broadly stable, dollar funding costs eased, and collateral performed well in December.

Looking ahead, recent Fed communication suggests that the current pace of bill purchases will continue into the second quarter, with a simultaneous reduction in the reliance on term and overnight repo. The Fed will continue offering repos at least through April in order to ensure an ample supply of reserves through tax season. Once the Fed assesses the level of reserves as having durably reached ample levels, the pace of reserve management purchases should decelerate to a rate in line with the trend growth of non-reserve liabilities.

In light of this financial and economic backdrop, the Committee reviewed Treasury's February 2020 Quarterly Refunding Presentation to the TBAC. Q1 2020 receipts were $48 billion (6%) higher than the same period in 2019. Increases in customs duties (due to new tariffs), withheld income and FICA taxes, as well as gross corporate taxes, were the largest drivers. This was partially offset by a decline in excise taxes. Total outlays over the same period were $72 billion higher, an increase of 7%, driven by Health and Human Services as well as Social Security outlays, and Defense spending. Based on the Quarterly Borrowing Estimate, Treasury's Office of Fiscal Projections currently projects a net privately-held marketable borrowing need of $367 billion for Q2 FY 2020, with an end-of-March cash balance of $400 billion.

For Q3 FY 2020, the net privately-held marketable borrowing need is estimated to be negative $56 billion, with a cash balance of $400 billion at the end of June. 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). 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.

Treasury staff presented an overview on T-Bill market liquidity in light of continued SOMA purchases in this sector. Given current fiscal projections and assuming unchanged coupon auction sizes, the supply of privately-held T-Bills is expected to decline to the mid $1.8 trillion range by end of June 2020. This would be the lowest absolute level since October 2017 and within the range that primary dealers estimated to be the minimum supply needed to ensure benchmark liquidity. The Committee agreed to monitor the sector closely as this will be the second consecutive quarter that T-Bill issuance will be lower than TBAC's prior guidance (that between one quarter and one third of the financing gap should be met with T-Bill issuance). 2020 may mark a low point for front end supply but this should rise meaningful as the financing gap increases in 2021 and 2022.

Treasury staff reviewed primary dealers' recommendations on initial size for the 20-year issue, which was announced on January 16th. Most dealers expect a first issue to take place in May, with a small initial issuance size given current fiscal projections. Dealers expected an inaugural size of $10-13 billion for the new issue with subsequent monthly re-openings of $8-11 billion, for a total coupon size of $26-35 billion. Dealers broadly expect the size of the 20-year to increase over time as Treasury's financing needs grow.

The Committee discussed financing strategies to accommodate current fiscal projections, the announced introduction of a 20-year issue in the first half of 2020, and continued Federal Reserve T-Bill purchases. With longer term funding needs expected to rise in 2021 and 2022 and with the expectation of broad end-user demand, the Committee supports the introduction of the new 20-year issue in May, sized at the lower end of primary dealer's expectations. The Committee feels strongly that a regular and predictable issuance strategy is critical to achieving the lowest cost to the taxpayer over time, and consistent with that view, does not recommend changes to other coupons in the near term. This does not indicate a departure from the Committee's prior views of the longer-term strategy of maturity composition of Treasury debt.

Further, the Committee reiterated its view that the WAM of the debt, while not an explicit target, is adequate and noted prior discussions which suggest issuance in the belly is preferable over the long end given the cost/risk trade off.

The Committee continues to expect little or no change to coupon sizes for much of FY 2020, with the exception of modestly increasing 20-year supply. 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 through 2021 and 2022. 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 next reviewed a charge on whether Treasury should alter its issuance pattern if the Federal Reserve shifts its SOMA holdings toward shorter-dated securities as discussed during the April/May 2019 FOMC meeting. The presenters highlighted that while Treasury and the Federal Reserve are independent entities operating with different mandates, decisions that the Federal Reserve makes on its SOMA portfolio will have an impact on Treasury, because the Federal Reserve remits most of the interest earned on its SOMA holdings to Treasury. Thus, it can be useful to look at a stylized consolidated balance sheet across Treasury and SOMA when considering some debt management considerations.

The presenters demonstrated that, from the perspective of a stylized consolidated balance sheet, SOMA portfolio holdings replicate the effects of the Treasury having issued more floating-rate notes tied to overnight interest rates set by the Fed. That effect, combined with the presence of currency as a SOMA liability, has produced a better cost/risk trade-off for Treasury than would have been the case without the SOMA.

The presenters highlighted that any decision by the Federal Reserve to run off its SOMA holdings would increase Treasury's borrowing needs, as Fed add-ons would decline. The potential shift towards shorter-dated securities in SOMA could give the Federal Reserve considerable capacity to run off its holdings over short periods. However, a decision by the Federal Reserve to employ run off caps, as it did in its most recent portfolio decline, would help the Treasury to maintain its regular and predictable approach to debt issuance.

The presenters argued that Treasury should adjust supply to meet a desired shift by the Federal Reserve in the longer-run SOMA maturity structure, thereby keeping the composition of privately-held securities unaffected. Altering Treasury issuance to the private sector to offset the desired shift by the Federal Reserve would not significantly reduce the risk involved and would result in a less favorable cost/risk outcome for the taxpayer.

Finally, the Committee discussed whether Treasury should alter its issuance plans in a future QE episode. In light of Treasury’s overall economic growth mission, the Committee believes Treasury should not adjust, over the short run at least, its maturity composition in response to QE in a way that offsets the effects of the Federal Reserve’s policy.

Respectfully,

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Beth Hammack

Chair, Treasury Borrowing Advisory Committee

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Daniel Dufresne

Vice Chair, Treasury Borrowing Advisory Committee