

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



August 5, 2020

August 4, 2020

Letter to the Secretary

Dear Mr. Secretary:

Economic activity plunged in the second quarter of 2020, with a 32.9% annualized decline in real GDP, by far the largest quarterly decline in post-war history. The coronavirus outbreak has weighed heavily on the US economy, with widespread lockdowns significantly constraining economic activity. Since the peak decline in activity in April, the economy has started to reopen and activity has picked up, but it still remains well below levels prior to the pandemic. Going forward, the course of the virus will play a large role in determining the trajectory of the economy.

Since the Committee last met, the Federal Open Market Committee (FOMC) maintained the target range for the federal funds rate at the effective lower bound of 0%-0.25%. Despite the large contraction in economic activity, overall financial conditions have eased significantly since tightening sharply in the early stages of the virus outbreak. Equity prices increased 13% on net since the last refunding, and are now roughly flat since the beginning of the year. The 2-year Treasury yield and the 10-year Treasury yield both declined slightly since the Committee last met, while the trade-weighted dollar index has declined roughly 4% on net.

Consumer spending fell at a 34.6% annualized rate in the second quarter, following a 6.9% annualized decline in the first quarter of the year. Services spending decreased at a 43.5% annualized rate, driven by declines in face-to-face sectors such as health care, transportation, recreation, and food services. Nondurable goods spending decreased at a 15.9% rate, while durables spending declined at a 1.4% rate. Measures of consumer confidence and consumer sentiment have declined significantly since the start of the virus outbreak, but remain above levels during the last recession. While consumer spending has picked up meaningfully since

April, high-frequency data have recently shown a slowdown in spending growth coinciding with a deteriorating virus situation in many states.

Business fixed investment fell at a 27% annualized rate in the second quarter. Structures investment declined at a 34.9% annualized rate and equipment investment fell at a 37.7% rate, while investment in intellectual products decreased at a 7.2% rate. The change in inventory investment subtracted 4 percentage points from GDP growth in the second quarter. Regional manufacturing surveys have picked up significantly in June and July, after collapsing during the initial stages of the virus outbreak. The Federal Reserve's Beige Book also indicated a pickup in manufacturing activity from a very low level, but contacts reported that the outlook remained highly uncertain.

Residential investment decreased at a 38.7% annualized rate in the second quarter, following three consecutive quarterly increases. However, new home sales, housing starts, and permits all showed sequential improvement in May and June, and surveys of home builders have also showed a renewed sense of optimism. Mortgage rates have declined to historically low levels, which should continue to provide a boost to housing activity.

Net exports contributed 0.7pp to real GDP growth in the second quarter. Real exports decreased at a 64.1% annualized rate while real imports fell at a 53.4% annualized rate, following large declines in both in the first quarter of the year. Federal spending increased at a 17.4% annualized rate in the second quarter, while state and local spending fell at a 5.6% rate.

The federal deficit is expected to increase sharply this year largely due to fiscal relief measures including aid to unemployed workers and state and local governments, tax cuts and payments to individuals, and loans and tax benefits for businesses. Income replacement from fiscal support has likely played a large role in supporting consumer spending in the face of large job losses, and fiscal negotiations are currently under way as expanded unemployment benefits are set to expire.

Following an unprecedented surge in layoffs during the initial stages of lockdowns, the labor market has improved, but still remains far from the pre-virus norm. Nonfarm payrolls increased by 7.5mn in May and June following a 22.2mn decline in the months of March and April. The unemployment rate declined by 2.2pp to a still highly elevated 11.1% in June, while the broader underemployment rate declined by 3.2pp to 18.0%. The labor force participation rate increased by 0.7pp to 61.5% in June, and the employment-to-population ratio increased by 1.8pp to 54.6%, compared to roughly 61% prior to the coronavirus.

Consumer price inflation has remained soft, with disinflationary pressures from the collapse in demand in virus-sensitive sectors outweighing any inflationary supply pressures. The total personal consumption expenditures price index declined at a 1.9% annualized rate in the second quarter, while the core measure excluding food and energy declined at a 1.1% rate. The core measure rose 1.0% over the last four quarters, well below the Federal Reserve's 2% target.

In addition to keeping the funds rate at the effective lower bound in the June and July meetings, FOMC participants made changes to their interest rate projections at the June meeting. The median projected path for the funds rate showed no change in 2020-2022, with one participant showing one rate hike and one participant showing four rate hikes in 2022. Recent Fed communication and the FOMC statement have also indicated that the funds rate will remain at the lower bound for an extended period. Since the last refunding, the FOMC has announced it will increase its holdings of US Treasury securities and residential and commercial MBS at a pace of around \$80 billion per month for Treasury securities and \$40 billion per month for agency MBS.

In light of this financial and economic backdrop, the Committee reviewed Treasury's August 2020 Quarterly Refunding Presentation to the TBAC. Q3 2020 receipts were \$351 billion (13%) lower than the same period in 2019 due mainly to the change in tax deadlines to July 15th. Total outlays over the same period were \$1,648 billion higher, an increase of 49% relative to the comparable period in 2019, mainly due to payments related to COVID-19 relief efforts. Based on the Quarterly Borrowing Estimate, Treasury's Office of Fiscal Projections currently projects a net privately-held marketable borrowing¹ need of \$947 billion for Q4 FY 2020, with an end-of-September cash balance of \$800 billion. This estimate is \$270 billion higher than announced in May, driven by expenditures from new legislation to assist individuals and businesses through the COVID-19 outbreak. For Q1 FY 2021, the net privately-held marketable borrowing need is estimated to be \$1,216 billion, with a cash balance of \$800 billion at the end of December. Both of these estimates include \$1 trillion of additional COVID-19 stimulus.

The Committee discussed the elevated cash balance that Treasury has held in recent months and projects to hold for some time. Treasury explained that the higher cash balance resulted from the large and highly uncertain need for funds amid considerable uncertainty about the path of fiscal policy and the timing of the associated projected payments. TBAC members noted that maintaining a higher cash balance during this highly uncertain period was a prudent strategy, but that balances had far outstripped expectations, raising some questions in the marketplace. Treasury's approach has been precautionary given the significant risk of

forecasting error in this unprecedented environment and its desire to be able to disburse funds quickly to support the economy.

Treasury staff presented an overview of net issuance assuming coupon sizes remained the same as announced on FYQ3. In such case, net coupon issuance would be \$447bn and T-Bill issuance would need to increase by \$500 billion to meet the projected financing need. At the end of June, private T-Bill holdings had increased to \$4,754 billion – a new all-time high -- and T-Bills holdings as a share of marketable debt outstanding have risen to 25.5% -- above the historical average of 22.7%. Treasury staff highlighted that demand for T-Bills remained robust throughout the recent issuance, bid-to-cover ratios remained stable across the curve, and foreign demand increased modestly. Committee members agreed with that assessment, noting that the bill market had acted as a robust source of funding amid a rapidly changing fiscal environment.

The Committee also noted that the new 20-year issuance has been well received by investors, despite its larger than expected initial size. Members noted that longer-term Treasury yields remained near historical lows amidst the current environment of continued expectations of low short-term interest rates and significant negative net supply of coupon securities year-to-date when accounting for Fed purchases. Still, members noted some pressure on long end yields as evidenced by swap spreads becoming more negative relative to late last year, possibly driven by expectations of increased long end issuance.

Treasury staff reported that Treasury's recent RFI indicated solid support for a 1-year SOFR FRN, with expected demand from money market funds and foreign governments. The Committee agreed with feedback that a SOFR FRN would support the transition away from LIBOR, as it would help to further establish market standards for issuance, encourage technological investment, support development of a term rate, and increase liquidity SOFR-indexed products. The Committee was unanimously supportive of Treasury moving forward with a SOFR FRN, preferably relatively early in FY2021, and encouraged Treasury to finalize the design of the security and complete associated implementation efforts in a timely manner.

The Committee next reviewed a charge on how Treasury should shift issuance to manage its maturity profile, given that the immediate funding needs related to the COVID-19 outbreak had been met primarily through T-Bill issuance. Given these issuance patterns, the maturity of outstanding debt has fallen notably, with about 37% of outstanding Treasury debt maturing within one year and 59% maturing within three years. The presenter reviewed debt

management options in light of several key aspects of the current environment. In looking at this issue, the presenter partially relied on the macroeconomic outlook and TBAC's debt issuance model previously developed by several TBAC members, while noting that it is only one analytical tool to consider.

The presenter highlighted that several aspects of the current environment may make it desirable to extend issuance from shorter maturities into term securities, particularly ones with maturities out to ten years. Given the proximity to the zero lower bound on interest rates, issuance in the 5- to 10-year sectors is attractive to protect against rising rates and to realize desirable correlations between funding costs and the primary deficit. This conclusion was supported by the debt issuance model which had previously favored issuance in maturities 5-years and under. The presenter noted that increased TIPS issuance would also provide the Treasury with a useful hedge against weaker growth and higher deficits. While coupons will likely need to increase across the curve to accommodate historically large funding needs, several measures indicate that the term premium on long-term Treasuries remains elevated relative to the belly of the curve. As a result, focusing the largest increases on issuance in maturities out to 10 years and in TIPS appears to be more desirable than concentrating issuance in longer instruments.

The Committee member also noted that extending issuance into term maturities would mitigate some of the funding risk associated with any future decision by the Fed to run-off some of its SOMA holdings. Lastly, the member argued that demand for T-Bills would likely remain elevated in the current environment, given the rise in private savings and the willingness of banks to substitute from reserves into T-Bills. As a result, the T-Bill market should continue to be an effective shock absorber for unexpected financing needs. Most members felt that, over time, Treasury should maintain the share of T-Bills outstanding within historical ranges, and not increase the overall share above those levels, in order to retain capacity for the T-Bill market to serve this role effectively.

The Committee discussed financing strategies to accommodate revised fiscal projections amidst continued fiscal and economic uncertainty owing to the COVID-19 epidemic. The Committee endorsed a gradual increase of coupon sizes in line with Treasury's regular and predictable issuance strategy to achieve the lowest cost to taxpayers over time. The Treasury's debt management decisions in May had placed a larger amount of issuance in longer-term maturities than recommended by TBAC at the time. While that issuance was met with robust demand over

the quarter, Committee members noted that the supportive market conditions likely reflected several factors that may not be sustained over the intermediate term. The Committee continues to recommend increases in issuance sizes across all maturities, but suggests that increases in maturities out to 10 years should be somewhat larger than increases in the long end. The Committee also recommends modest increases in TIPS issue sizes. These changes would allow Treasury to lengthen the maturity profile of its debt back to its pre-COVID levels by late 2022.

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 further changes in funding needs, market functioning and shifting demand preferences.

Respectfully,

Beth Hammack

Chair, Treasury Borrowing Advisory Committee

Daniel Dufresne

Vice Chair, Treasury Borrowing Advisory Committee

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.