


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



November 4, 2020

November 3, 2020

Letter to the Secretary

Dear Mr. Secretary:

Economic activity rose sharply in the third quarter of 2020, with a 33.1% annualized increase in real GDP. The economy has recovered rapidly from the largest quarterly contraction in post-war history, but real GDP still remains 2.9% below year-ago levels. Going forward, the course of the virus will play a large role in determining the trajectory of the economy, and increasing virus spread in many parts of the country poses significant near-term downside risk.

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%. Overall financial conditions have remained at similar levels since the last refunding. Equity prices and the 2-year Treasury yield have remained roughly flat on net since the Committee last met, while the 10-year Treasury yield has increased slightly. The trade-weighted dollar has declined by 2.4% on net since the last refunding.

Consumer spending rose at a 40.7% annualized rate in the third quarter, following a 33.2% annualized contraction in the second quarter of the year. Services spending increased at a 38.4% annualized rate, nondurable goods spending increased at a 28.8% rate, and durable goods spending surged at an 82.2% rate. The recovery in consumer spending has varied widely by industry, with overall goods spending 6.9% higher than year-ago levels, but services spending still 7.2% below year-ago levels. The slower recovery in services reflects continued weakness in face-to-face sectors such as transportation, recreation, and food services.

Business fixed investment increased at a 20.3% annualized rate in the third quarter, and remains 5.0% below year-ago levels. Structures investment fell further at a 14.6% annualized

rate, equipment investment rose sharply at a 70.1% rate, and investment in intellectual products edged down at a 1.0% rate. The change in inventory investment contributed 6.6 percentage points to GDP growth in the third quarter. Regional manufacturing surveys have continued to show increased levels of activity through October. The Federal Reserve's Beige Book also indicated that manufacturing activity has continued to increase at a moderate pace, although many contacts reported a high level of uncertainty around the virus, the upcoming presidential election, and further possible fiscal stimulus measures.

Residential investment surged at a 59.3% annualized rate in the third quarter, to a level 6.6% above that a year ago. The pace of new and existing home sales has well surpassed the pre-virus rate in recent months, while housing starts and permits have also rebounded back to strong levels. While much of the recent strength can be explained by pent-up demand from sales that would have occurred in the spring if not for the virus, many surveys indicate that the virus has created increased demand for homeownership. Mortgage rates remain at historically low levels and should continue to support the housing sector, and surveys of home builders have reached all-time highs.

Net exports subtracted 3.1pp from real GDP growth in the third quarter. Real exports increased at a 59.7% annualized rate while real imports increased at a 91.1% annualized rate, following sharp declines in both in the second quarter of the year. Federal spending fell at a 6.2% annualized rate in the third quarter, while state and local spending declined at a 3.3% rate.

The federal deficit increased sharply to \$3.1 trillion in fiscal year 2020, based on the Congressional Budget Office's estimates. The deficit largely reflected fiscal relief measures taken during the recession, which supported consumer spending and small businesses in the face of large job losses and an unprecedented decline in business revenues. Recent fiscal negotiations have not yet materialized into a new stimulus package, and the expiration of extra unemployment insurance benefits presents downside risk to consumer spending in the coming months.

The labor market has improved rapidly, but employment remains well below levels prior to the pandemic. Nonfarm payrolls increased by 661k in September, a deceleration from the 1.6mn monthly pace of job gains in July and August. The unemployment rate declined by 0.5pp to 7.9% in September, while the broader underemployment rate declined by 1.4pp to 12.8%. The labor force participation rate fell by 0.3pp to 61.4%. The employment-to-

population ratio increased by 0.1pp to 56.6%, compared to roughly 61% prior to the pandemic.

Consumer price inflation has picked up but remains soft on a year-over-year basis. The total personal consumption expenditures price index increased at a 3.7% annualized rate in the third quarter, while the core measure excluding food and energy increased at a 3.5% rate. The core measure rose 1.4% over the last four quarters, well below the Federal Reserve's 2% target. While the disinflationary pressure from the collapse in demand in virus-sensitive sectors has abated somewhat, the shortfall in year-over-year inflation remains concentrated in these virus-sensitive categories.

In late August, the FOMC adopted a flexible form of average inflation targeting as the key outcome of its monetary policy framework review. The FOMC simultaneously released an updated Statement on Longer-Run Goals and Monetary Policy Strategy, and under the new approach the FOMC will respond only to "shortfalls" of employment from its maximum level rather than to all "deviations" above or below the maximum level. In addition, the updated statement notes that appropriate monetary policy would aim to achieve inflation moderately above 2 percent following periods when inflation had been running persistently below 2 percent.

In addition to keeping the funds rate at the effective lower bound in the September meeting, the FOMC provided new forward guidance for the policy rate. The FOMC adopted outcome-based liftoff criteria where it expects to maintain the current policy target range until the labor market reaches maximum employment, and inflation has risen to 2 percent and is on track to exceed 2 percent for some time. The median projected path for the funds rate in the September Summary of Economic Projections showed no change through 2023, although four participants project at least one hike by then. The FOMC continues to increase its holdings of US Treasury securities at a pace of around \$80 billion per month and its holdings of agency mortgage-backed securities at around \$40 billion per month.

In light of this financial and economic backdrop, the Committee reviewed Treasury's November 2020 Quarterly Refunding Presentation to the TBAC. Through Q4 2020 receipts were \$42 billion (1%) lower than the same period in 2019. Total outlays over the same period were \$2,105 billion higher, an increase of 47% relative to the comparable period in 2019, mainly due to payments related to COVID-19 relief efforts. FY20 outlays were 31.2% of GDP, compared to 21.0% of GDP for FY19. Based on the Quarterly Borrowing Estimate, Treasury's Office of Fiscal Projections currently projects a net privately-held marketable borrowing<sup>1</sup>

need of \$617 billion for Q1 FY 2021, with an end-of-December cash balance of \$800 billion. For Q2 FY 2021, the net privately-held marketable borrowing need is estimated to be \$1,127 billion, with a cash balance of \$800 billion at the end of March. Both of these estimates include \$1 trillion of additional COVID-19 stimulus.

The Committee again noted the elevated cash balance that Treasury has held in recent months and projects to hold for some time due to 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. 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. TBAC members agreed that maintaining a high cash balance during this highly uncertain period was a prudent strategy.

Treasury staff presented an overview of net issuance assuming coupon sizes remained the same as announced in FYQ4. In that case, net coupon issuance this quarter would be \$623bn, and the outstanding amount of T-Bills would decline by \$6 billion to meet the projected financing need. At the end of September, private T-Bill holdings remain near all-time highs at \$4,703 billion -- and T-Bills holdings as a share of marketable debt outstanding stood at 24.7% -- above the historical average of 22.7%.

Committee members had hoped that Treasury would make a decision to announce a SOFR FRN. Members acknowledged the significant private and public sector work currently underway on the transition, including the recent clearinghouse moves to SOFR discounting and the launch of the ISDA fallback supplement and protocol. Treasury has been an active participant in ARRC and has provided helpful guidance on tax treatment of derivatives subject to the transition, but the Committee strongly believes that Treasury should also be a leader in terms of its issuance decisions. The Committee therefore continues to unanimously support Treasury issuance of a SOFR FRN. Specifically, the Committee expects that issuance by the Treasury would help to further establish market standards for notes, encourage technological investment, support development of a term rate, and increase liquidity of SOFR-indexed products. The Committee continues to encourage Treasury to finalize any remaining issues on security design and implementation, and move forward with issuing a SOFR FRN, as soon as practicable, ideally in FY2021.

The Committee next reviewed a charge on supply and demand dynamics in the T-Bill sector and appropriate levels of T-Bill issuance in the medium- and longer-term. The presenters discussed the robust demand for T-Bills from Money Market Funds (MMFs) given meaningful

inflows into Government MMFs and the increased allocation to T-Bills in both Prime and Government MMFs. The presenters highlighted that these types of inflows are typical in moments of market and economic stress and often coincide with increased T-Bill issuance.

The presenters noted that demand would likely sustain a T-Bill share of outstandings (T-Bill share) at levels above the historical average for some time given the current economic environment. However, the Committee continues to believe that extending the maturity structure of Treasury debt, particular into maturities out to 10 years, is desirable to protect against rising rates and to minimize operational risk with frequent issuance. Moreover, reducing the share of T-bills would better enable them to continue serving as an effective shock absorber for unexpected financing needs. Based on these considerations, the Committee recommended allowing the share of T-Bills to decline gradually to a range of 15% to 20% of outstanding debt.

The Committee next discussed financing strategies to accommodate revised fiscal projections amidst continued fiscal and economic uncertainty owing to the COVID-19 epidemic and today's election. Prior increases in coupon issuance will continue to result in sizable net funding to Treasury for several years and are expected to extend the weighted-average maturity of the debt over time. Given the possibility of additional fiscal stimulus, the Committee endorsed continued increases of coupon sizes this quarter, although with a larger deceleration of the issuance at the longer maturities. The Committee assumed that issuance would slow further across all maturities in the next quarter, although this outcome will depend on how projected funding needs evolve.

While Treasury issuance was met with solid demand over the quarter, Committee members noted that yields had risen and the curve had steepened notably since the August refunding, with 2- year notes only 5bps higher, but 5-, 10- and 30-year tenors 20bps, 38bps, and 50bps higher respectively. Members pointed to several factors driving the sell-off in long end yields in addition to supply, including the improvement in economic conditions, market expectations of further fiscal stimulus, and the Federal Reserve's adoption of a Flexible Average Inflation Targeting approach. Committee members thought that this confluence of factors had on balance driven the term premium higher for longer-term maturities.

The Committee further recommends moderate increases in TIPS issue sizes. Given the meaningful increases in debt issuance in 2020, TIPS share of outstanding debt has fallen to 7.5% from around 9% in the pre-COVID period. The Committee is supportive of increases in TIPS supply to gradually move their share of debt outstanding in the direction of pre-COVID

levels and recommends that Treasury should continue to monitor market functioning and the relative valuation of TIPS to nominal securities as this adjustment takes place.

Overall, these gradual adjustments, in line with Treasury's regular and predictable issuance strategy, should allow Treasury to continue reducing funding risk, while maintaining flexibility to accommodate further meaningful funding needs should they arise. These changes would be expected to lengthen the maturity profile of its debt back to its pre-COVID levels over time. Of course, given the considerable uncertainty surrounding current fiscal projections, the economy, and the Fed's balance sheet policy, Treasury will need to retain flexibility in its approach.

Respectfully,

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Beth Hammack  
Chair, Treasury Borrowing Advisory Committee

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Brian Sack  
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.