

Report to the Secretary of the Treasury from the Treasury Borrowing Advisory Committee



February 2, 2022

February 1, 2022

Letter to the Secretary

Dear Madam Secretary:

Economic activity rose at a faster pace in the fourth quarter of 2021, in part reflecting recovery from the impact of the Delta variant in Q3. Real GDP grew at a 6.9% annualized rate, above consensus expectations, though this reflected a 4.9pp contribution from inventory accumulation.

Since mid-December, the spread of the Omicron variant has reduced spending and disrupted operations in many industries. In particular, the number of workers who were temporarily unavailable to work for virus-related reasons increased sharply. Thousands of flights were cancelled because of staff shortages, office occupancy declined as companies delayed return-to-office plans, and both restaurant and air travel spending declined. These setbacks now appear to be diminishing in the US as virus cases fall. However, many other countries have tightened Covid-related restrictions, and concerns remain about spillover effects to the US economy from disruptions caused by virus-suppression efforts abroad.

Forecasters expect the economy to decelerate in Q1, reflecting the impact of both Omicron and reduced fiscal support, including the end of the expanded child tax credit. While further fiscal negotiations are ongoing, most analysts expect a substantial decline in total fiscal support in 2022 from elevated levels in 2021. Additional reopening of the service sector could further restore normal spending opportunities, especially if advances in treatments and testing further reduce Covid fears.

Payroll employment gains averaged 365k per month in 2021Q4, and the unemployment rate fell to 3.9% in December, a 0.8pp decline since September. The labor force participation rate rose 0.2pp to 61.9%, but remains well below the pre-pandemic trend. Total labor demand, summing the number of workers employed and job openings, remains at the pre-pandemic

level. In contrast, the labor force remains 2.3 million workers short of the pre-pandemic level. This has led to a very tight labor market and strong wage growth in recent quarters.

Inflationary pressures have remained strong in recent months. Core goods prices have grown quickly as auto prices have reaccelerated and supply-side problems have persisted, core services prices have grown at a faster pace recently as rent growth has picked up, and food and energy prices have risen quickly too. Short-term inflation expectations remain very high.

The Federal Reserve announced that it will finish tapering its asset purchases in March. A rate hike at the March meeting is widely expected, and the Federal Open Market Committee (FOMC) has also begun to discuss shrinking its balance sheet. Chair Powell recently emphasized that the economy is in a different place than it was in the last hiking cycle and that the FOMC must be in a position to adjust policy in a nimble manner. Market expectations for policy rate hikes in 2022 have been brought meaningfully forward, implying over 4 hikes in 2022, and broader financial conditions have begun to tighten.

Since the last refunding, equity prices have fallen by roughly 4% (down 8% since the peak), and the trade-weighted dollar rose by 3%. Interest rates have continued to rise amidst a meaningful flattening of the yield curve, with the 2-year Treasury yield up 70bps to 1.16% and the 10-year yield increasing 23bps to 1.78%. The long end has remained quite contained, with the 30-year yield rising only 14bps to 2.10%.

In light of this financial and economic backdrop, the Committee reviewed Treasury's February 2022 Quarterly Refunding Presentation. Based on the marketable borrowing estimates published on January 31, the Treasury currently projects a net privately-held marketable borrowing¹ need of \$729 billion for Q2 FY 2022 (Q1 CY 2022), with an end-of-March cash balance of \$650 billion. For Q3 FY 2022 (Q2 CY 2022), the net privately-held marketable borrowing need is estimated to be \$66 billion, with a cash balance of \$700 billion at the end of June. These estimates do not include impacts from any additional legislation that could potentially be passed.

The Committee reviewed one charge that considered the market impact of recent coupon reductions and discussed recent developments that will affect the path of auction sizes going forward. Though Treasury delivered coupon reductions broadly in line with expectations in the previous refunding quarter, the 7- and 20-year maturity points continued to cheapen under several relevant metrics, which members felt reflected insufficient end-user demand relative to the amount of supply. Going forward, Treasury's funding outlook has evolved in several important ways, most notably the timing of reductions in the Federal Reserve's SOMA

portfolio, which are now expected to begin around mid-year and to be sizable. This shift would increase the amount of debt that the Treasury needs to raise from the private sector.

Given this shift, TBAC believes that Treasury should slow or halt coupon reductions sooner than previously anticipated, though there is still considerable uncertainty regarding the path and timing of SOMA reductions. We reviewed several possibilities for future Treasury issuance assuming runoff begins in July 2022 and ends when SOMA reaches 23% of nominal GDP. Several cap sizes for runoff were used to evaluate four hypothetical paths for future issuance. The Committee unanimously agreed that Treasury should continue with cuts in auction sizes for its coupon securities this quarter at the same pace as the prior quarter (\$2 billion per month in 2-, 3-, and 5-year notes, \$3 billion per month in 7-year notes, \$2 billion per quarter in both new issues and reopening of 10- and 30-year securities and \$4 billion in 20-year securities). This path would continue to reduce the supply of 7-year and 20-year securities by a disproportionate amount to address the imbalance noted above and would help to maintain T-bill share within TBAC's recommended range of 15-20%.

Members expect that a smaller set of reductions would be desirable for the May quarter in total and that auction sizes would level out after that. The Committee debated whether cuts in May should be expected across the curve or primarily in longer maturities. Given that SOMA holdings can be viewed as floating-rate notes for the consolidated government balance sheet (see February 2020 TBAC discussion), and considering that the maturity and duration of the debt is rising (particularly on a consolidated basis), the Committee modestly favored focusing further reductions in the longer end, leaving 2- through 5-year maturities untouched at the May refunding. The Committee recognizes that a wide range of funding needs are possible, especially with fiscal legislation still pending, and noted that it will be important to revisit the May refunding suggestion with the additional information that will be available at that time.

The Committee further recommends modest increases in TIPS issue sizes. Given the meaningful increases in nominal debt issuance in 2020, TIPS share of outstanding debt has fallen to around 7.5% from around 9% in the pre-COVID period. Modest increases in TIPS auction sizes would help increase this share over time, particularly in 5- and 10-years, but TBAC recommends continued monitoring of the sector and its performance.

Overall, the recommended path of auction sizes for the current and next quarter should allow Treasury to meet its financing needs in an efficient manner while maintaining flexibility to accommodate further meaningful funding needs should they arise. Over a longer horizon, this issuance path would lengthen the average maturity of Treasury debt and the average

duration of debt to levels modestly above their historical ranges; leave the T-bill share of outstanding debt within the recommended 15% to 20% range; and gradually increase the share of TIPS in outstanding debt. 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,

Beth Hammack

Chair, Treasury Borrowing Advisory Committee

Brian Sack

Vice Chair, Treasury Borrowing Advisory Committee

¹It was noted that privately-held marketable borrowing excludes rollovers (auction “add-ons”) of Treasury securities held in the Federal Reserve System Open Market Account (SOMA) but includes financing required due to SOMA redemptions. Secondary market purchases of Treasury securities by SOMA do not directly change net privately-held marketable borrowing but, all else equal, when the securities mature and assuming the Fed does not redeem any maturing securities, would increase the amount of cash raised for a given privately-held auction size by increasing the SOMA “add-on” amount (see pages 11 and 12 of accompanying deck).