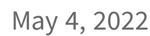
Report to the Secretary of the Treasury from the Treasury Borrowing Advisory Committee



May 4, 2022

May 3, 2022

Letter to the Secretary

Dear Madam Secretary:

Economic activity fell at a 1.4% pace in the first quarter of 2022, reflecting the large drag from a widening of the trade deficit. Consumption grew at a 2.7% annualized rate, and private-sector domestic final demand grew 3.7%, despite headwinds from Omicron early in the quarter and reduced fiscal support, including the expiration of the expanded child tax credit. Forecasters expect the economy to reaccelerate to a 3% growth pace in the second quarter.

A post-Omicron recovery appears to have been underway in recent months. The number of people not at work due to illness has continued to decline, and spending on travel and other virus-sensitive services has picked up, contributing to growth in consumer spending in the first quarter.

Supply-side challenges remain serious, however. Average supplier delivery times rose in March for the first time in several months, likely reflecting the impact of lockdowns in China, the Russian invasion of Ukraine, and other lingering problems in the manufacturing sector.

Payroll employment gains averaged 562k per month in 2022Q1, and the unemployment rate fell to 3.6% in March, a 0.3pp decline since December and just 0.1pp above the pre-pandemic low. The labor force participation rate rose 0.5pp to 62.4% but remains below the pre-pandemic trend. The difference between total labor demand and total labor supply—the number of workers employed plus job openings minus the size of the labor force—is now 5.3mn workers. The tightness of the labor market supported further strong wage growth at a 5-6% pace in the first quarter, a rate that, if sustained, would likely keep inflation well above the Fed’s 2% target.

Inflationary pressures have remained strong in recent months. The core PCE measure rose at a 5.2% rate in the first quarter and 5.2% over the last year, while the headline CPI measure rose at a 9.2% rate in the first quarter and 8.6% over the last year, boosted by large increases in food and energy prices. Forecasters expect that inflation will decline from here but remain notably above the Fed's 2% goal this year and next. Short-term inflation expectations remain very high.

The Federal Reserve finished tapering its asset purchases and delivered a 25bp interest rate hike in March. A larger 50bp rate hike and the announcement of the start of its balance sheet reduction are widely expected at the May meeting, consistent with guidance from Fed officials that they intend to move "expeditiously" to confront the inflation challenge. Balance sheet reduction will likely be capped at $60bn per month of Treasury securities and $35bn per month of mortgage-backed securities, though the rate of mortgage runoff is likely to fall below the cap. Market expectations for further interest rate hikes have increased substantially and now imply an additional 200bp of tightening in 2022 after the May meeting and a further 50bp to the peak in the summer of 2023.

Since the last refunding, financial conditions have tightened in a fairly abrupt manner. Equity prices have fallen by roughly 6% (down 13% since the peak), and the trade-weighted dollar rose by 7%. Interest rates have continued to rise amidst a meaningful flattening of the yield curve, with the 2-year Treasury yield up 160bps to 2.73% and the rest of the curve in and around 3% (yield higher by 100-155bps).

In light of this financial and economic backdrop, the Committee reviewed Treasury's May 2022 Quarterly Refunding Presentation. Based on the marketable borrowing estimates published on May 2, the Treasury currently projects to pay down $26 billion of privately-held net marketable debt in Q3 FY 2022 (Q2 CY 2022), with an end-of-June cash balance of $800 billion. This is largely driven by increased individual non-withheld tax receipts. For Q4 FY 2022 (Q3 CY 2022), the net privately-held marketable borrowing need is estimated to be $182 billion, with a cash balance of $650 billion at the end of September. These estimates do not include impacts from SOMA portfolio redemptions or any additional legislation that could potentially be passed.

The Committee reviewed a charge on the recent volatility in the Treasury market and its effects on market functioning. Treasury yields have moved considerably in response to the shift in inflation prospects and the expected path of monetary policy. Some measures of market functioning – trading volumes, turnover, and fitted curve errors -- are within historical

ranges, and short-term funding markets are not showing signs of stress. However, coupon market depth has dropped notably, and bid-ask spreads have widened somewhat, particularly in the front end, reflecting the increased volatility and uncertainty in the macro outlook. The group discussed how this market functioning might progress given that many central banks are removing accommodation. Some members are concerned about the limited elasticity of dealer balance sheets amidst increasing debt stock and elevated VAR levels. The Committee agrees that market functioning is not obviously problematic at this time but recommends that Treasury continue to monitor the market for any signs of further deterioration in market liquidity.

The Committee also reviewed a charge analyzing whether the 17-week (or 4-month) Treasury bill, which has been used regularly as a Cash Management Bill, should become a new benchmark point. This maturity has been well received by investors, receiving higher bid-to-cover ratios than other points. Moreover, given the longer-term outlook for bill supply, there is adequate space to fit this security into the regular auction schedule while maintaining other bill sizes in their recent ranges. Based on those arguments, the Committee supports moving the 17-week bill to a benchmark point.

The Committee then discussed the financing recommendations for the current and subsequent quarter. At the February meeting, members had expected that a smaller set of reductions focused on longer maturities would be desirable for the May quarter. However, given the notable reduction in borrowing needs this quarter and with the share of bills in outstanding debt already near the lower end of TBAC's recommended range, the Committee recommends reductions across the nominal coupon curve. Specifically, the Committee recommends reductions of $1 billion per month in 2-, 3-, 5-year notes, $2 billion per month in 7-year notes, $1 billion per quarter in both new issues and reopening of 10- and 30-year securities, and $3 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 bring supply more in line with longer-term demand, and it would help to maintain T-bill share within TBAC's recommended range of 15 to 20 percent. Auction sizes are expected to level out next quarter, though the group acknowledges Treasury may need to consider further reductions based on evolving fiscal needs.

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 is expected to gradually 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 the economy and projected borrowing needs, Treasury will need to retain flexibility in its approach and consider additional cuts if recent trends in receipts continue.

Respectfully,

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Beth Hammack

Chair, Treasury Borrowing Advisory Committee

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Brian Sack

Vice Chair, Treasury Borrowing Advisory Committee

[1]It 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).