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

August 3, 2022

August 2, 2022

Letter to the Secretary

Dear Madam Secretary:

Economic activity fell at a 0.9% pace in the second quarter of 2022, reflecting weaker demand growth and a 2pp drag from a decline in the pace of inventory accumulation. Residential investment declined at a 14% annualized rate as rising mortgage rates weighed heavily on the housing sector, business investment was roughly unchanged, and consumption grew at a 1.0% annualized rate. The rotation in consumer spending from goods to services continued, with real goods spending falling at a 4.4% annualized rate and real services spending rising at a 4.1% annualized rate.

The second consecutive quarter of contraction in GDP raised concerns about recession. But other measures of economic activity such as real personal income excluding transfer payments and industrial production rose, and forecasters expect GDP to grow again in the third quarter.

A deceleration is also apparent in the labor market. Monthly payroll employment gains averaged 375,000 in the second quarter, but household employment declined an average of 116,000 per month, an unusually wide gap. Average hourly earnings continued to decelerate in the second quarter, but the Atlanta Fed's Wage Growth Tracker accelerated, and the employment cost index continued to rise quickly. Overall, wage growth remains consistent with inflationary pressures in excess of the 2% inflation target, reflecting the continued tightness of the labor market. Labor demand remains very high, though job openings fell modestly, and labor supply remains below the pre-pandemic level.

Both core and headline measures of consumer price inflation remained high in the second quarter. The headline CPI rose 9% over the year ending in June as both food and energy prices rose rapidly, though commodity prices have declined more recently. The core measures

showed broad-based strength in recent months, including an acceleration in the large and usually persistent shelter category. Short-term inflation expectations remain very high.

The Federal Reserve delivered a second 75bp interest rate hike in July, completing its plan to "expeditiously" raise the target range for the funds rate to its 2.5% estimate of the longer-run neutral level. The median projection from the FOMC's Summary of Economic Projections implies a further 100bp of total rate hikes across its three remaining meetings in 2022, similar to bond market expectations, followed by an additional 37.5bp of tightening in 2023.

Since the last refunding, equity prices fell sharply and then rebounded, ultimately coming into this refunding down only slightly on net, and the trade-weighted dollar rose by 2%. The yield curve inverted as the 2-year Treasury yield rose 16bps to 2.89% and the 10-year yield fell 32bp to 2.67%.

In light of this financial and economic backdrop, the Committee reviewed Treasury's August 2022 Quarterly Refunding Presentation. Based on the marketable borrowing estimates published on August 1, Treasury currently projects net marketable borrowing of $444 billion in Q4 FY 2022 (Q3 CY 2022), with an end-of-September cash balance of $650 billion. The borrowing estimate is higher than at the May refunding, most notably because SOMA portfolio run-off was not included in the May projection. For Q1 FY 2023 (Q4 CY 2022), the net privately-held marketable borrowing need is estimated to be $400 billion, with a cash balance of $700 billion at the end of December. These estimates do not include impacts from any additional legislation that could potentially be passed.

Over the past several years members of the Committee have released tools to encourage broader understanding and analysis of debt management issues. The first of these was the optimal debt model developed by TBAC members in 2018. Since then, The Hutchins Center at the Brookings Institution, working with Committee members, has made the model publicly available on GitHub. Similarly, last week, a member released a Brookings blog post detailing one way to estimate the impact of current and future issuance decisions on the structure of Treasury debt, a consideration that the Committee faces when discussing its recommended financing tables. This code was also shared via GitHub. We hope these open-source tools are useful for market participants and researchers to better understand key debt management issues and provide additional perspectives on them. Of course, these tools represent only a limited portion of the analysis that is used to help inform debt management recommendations.

The Committee reviewed an update on the results from a model for determining the optimal structure of debt stock. The efficient frontier for the debt stock has shifted up and to the right over the period since 2019, meaning that the Treasury faces higher expected debt costs for a given amount of fiscal risk. The presenting member showed that this shift was largely driven by increases in the outstanding debt stock and less so by the macroeconomic environment. As a reminder, given the substantial mean-reverting properties of the model, the near-term environment does not have a large impact on the economic conditions that Treasury faces in the longer run. The model continues to illustrate the cost/risk advantages of issuance of TIPS, bills, and intermediate-term nominal coupon securities over long-end securities. Shifting issuance from longer maturities into those types of securities would offer expected savings with only a modest increase in risk.

While the model is a useful tool for quantifying costs and savings, it is only one of several factors considered when making recommendations. Moreover, the results are highly sensitive to the specific properties assumed in the model. The model results were largely intuitive, but there was also considerable interest in seeing results if some of the key model assumptions were varied, including some of the embedded correlations and the degree of mean reversion.

The Committee also reviewed a charge on Treasury buybacks. Treasury last regularly conducted buybacks in April of 2002 in response to federal budget surplus, and the Committee reviewed the topic at its February 2015 meeting. The market has changed significantly since those events, though the potential benefits of buybacks remain largely the same. Buybacks could help improve liquidity in off-the-run securities, reduce variation in bill issuance, and improve Treasury's cash management. However, buybacks would also require larger new issue sizes to maintain net issuance levels. Given the current size of new issues, the liquidity premium that Treasury could capture has been greatly reduced relative to where it was during the previous period of buybacks.

The Committee was mixed on whether the benefits of improved liquidity in off-the-run securities outweighed the costs of larger new issue sizes. The subject warrants further study. One compelling sector to explore seems to be the front end of the market, where Treasury could buyback short coupons (within 1-year to maturity) and issue bills in replacement. This would allow the Treasury to achieve liquidity premium benefits and enable improved cash management. More broadly, while ongoing buybacks could help support liquidity in off-the-run issues in general, it was argued that Treasury should not try to construct buybacks as a tool for sustaining market functioning during times of acute stress, as purchases generally need to

be funded by issuing other Treasury securities. Overall, the Committee was supportive of further analysis on this topic, while recognizing the challenges in design and need to better estimate the potential economic benefit.

The Committee then discussed the financing recommendations for the current and subsequent quarter. At the May meeting, members had expected that auction sizes would level out for the August quarter. However, many near-term deficit estimates have fallen, the share of bills in outstanding debt is expected to remain near the lower end of TBAC's recommended range, and market demand for bills is very strong. Thus, the Committee recommends further reductions across the nominal coupon curve. Specifically, the Committee recommends reductions of $1 billion per month in 2-, 3-, 5-, 7-year notes, $1 billion per quarter in both new issues and reopenings of 10- and 30-year securities, and $2 billion per quarter in both new issue and reopenings of 20-year securities. This path would reduce the supply of 20-year securities by a disproportionate amount to bring supply more in line with longer-term demand, and it would help to increase T-bill share close to the middle of TBAC's recommended range of 15 to 20% over time. Auction sizes are expected to level out next quarter, though the group acknowledges Treasury may need to consider adjustments based on evolving fiscal needs.

In the context of the financing recommendations, the Committee discussed the recent performance of the 20-year sector. While recent auctions have been well received, there appears to be an imbalance of securities outstanding relative to demand in the sector. The Committee was unanimous in its view that Treasury should remain committed to the 20-year maturity point to achieve its overall issuance goals and to maintain its regular and predictable strategy. The group posited that the imbalance was due to the much larger than recommended issue sizes from late 2020 and 2021 and that, with the recommended further reduction, the 20-year is reaching the range of sustainable issuance size that should be better aligned with future demand.

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 keep the average maturity of Treasury debt and its average duration roughly unchanged; 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.

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).