

# U.S. DEPARTMENT OF THE TREASURY

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

November 2, 2022

November 1, 2022

Letter to the Secretary

Dear Madam Secretary:

Economic activity rose at a 2.6% annualized rate in the third quarter of 2022, reflecting a softer 0.5% growth rate of final sales to domestic purchasers, but a large 2.8pp boost from net exports. Residential investment declined at a 26.4% rate as rising mortgage rates continued to depress housing activity. Business investment rose at a 3.7% rate, and consumption grew at a 1.4% rate. Consumer spending continued to rotate from goods to services, with real goods spending falling at a 1.2% rate and real services spending rising at a 2.8% rate.

The labor market began to rebalance in the third quarter but remains tight. Monthly payroll employment gains averaged 372,000 and household employment gains averaged 275,000 in the third quarter, as both payroll and household employment surpassed their pre-pandemic levels of February 2020 for the first time. Job openings declined sharply, but the layoff rate and weekly jobless claims remained low. The unemployment rate fell to its pre-pandemic rate of 3.5%, and the labor force participation rate rose slightly to 62.3%, somewhat below the pre-pandemic trend implied by demographic patterns. Wage growth decelerated slightly in the third quarter but remains well above estimates of the pace compatible with the 2% inflation target.

Core consumer price inflation remained high in the third quarter, led by a further rise in shelter inflation, which is expected to remain high next year as continuing tenants' rents catch up to new tenant market rates. Headline inflation slowed as CPI energy prices declined by 11.3% from June to September. Short-term inflation expectations remain very high.

The Federal Reserve delivered a third 75bp interest rate hike in September and is expected to

deliver a fourth 75bp rate hike in November, raising the target range for the funds rate to 3.75-4%. The median projection from the FOMC's Summary of Economic Projections implies a further 50bp hike in December and a 25bp hike in 2023, a bit below bond market expectations. The minutes to the September FOMC meeting indicated that many FOMC participants think that once the policy rate reaches a sufficiently restrictive level, it will likely be appropriate to keep it there until there is compelling evidence that inflation is on course to return to the 2% target.

Persistently high inflation and rapid interest rate hikes have led many forecasters and market participants to expect a recession next year. The average forecaster in an October Wall Street Journal survey saw a 63% chance of recession over the next 12 months, up from 49% in July.

Since the last refunding, financial conditions have tightened meaningfully. The GS Financial Conditions Index is 123bps higher with equity prices 6% lower and the trade-weighted dollar 5% stronger. The 2-year Treasury yield rose 154bps to 4.42% and the 10-year yield rose 137bps to 4.02%. The latter reflects both a higher expected peak in the Federal Reserve's current hiking cycle as well as a 153bp rise in the 5-year, 5-year forward rate. Primary credit markets are also showing signs of strain, with both investment grade and high yield spreads wider, and limited new issuance by lower rated credits.

In light of this financial and economic backdrop, the Committee reviewed Treasury's November 2022 Quarterly Refunding Presentation. Members were highly appreciative of the revised format and new charts inside including the illustrative projections for WAM (page 23), Bill share (page 25) and Maturity profile (page 26). The new Weighted Average Next Rate Reset (WANRR) chart illustrates different perspectives regarding the impact of SOMA holdings – showing this metric for total debt, privately-held debt, and a consolidated government balance sheet concept. Based on the marketable borrowing estimates published on October 31, Treasury currently expects privately-held net marketable borrowing of \$550 billion in Q1 FY 2023 (Q4 CY 2022), with an assumed end-of-December cash balance of \$700 billion. The borrowing estimate is higher than at the August refunding, primarily due to changes in projections of fiscal activity. For Q2 FY 2023 (Q1 CY 2023), privately-held net marketable borrowing is expected to be \$578 billion, with a cash balance of \$500 billion assumed at the end of March. The end-of-December and end-of-March cash balances assume enactment of a debt limit suspension or increase. While the debt limit is not currently binding, Treasury's cash balance may be lower than assumed depending on several factors, including constraints related to the debt limit.

The Committee briefly discussed the primary dealer responses regarding Treasury buybacks. Many of the primary dealers suggested that the Federal Reserve was better positioned to support the market in times of severe stress. However, a program in the context of Treasury's regular and predictable framework could be additive to market liquidity or could be a useful cash management tool. There were a range of views on how such a program would be implemented including how buybacks would be funded with additional issuance. Buybacks would represent a meaningful change in Treasury's strategy and come with significant operational complexity. Treasury should continue to gather information as to the benefits and risks of this activity for both cash management and liquidity purposes. Any efforts in this area should be carefully studied before considering implementation.

Our one charge was reviewing post-trade transparency in Treasury markets. First, we reviewed the impact of trade dissemination (i.e., public release of transaction-level data) in other fixed income markets, like swaps, corporates, and MBS. Most of the studies see a tightening in bid/offer at the expense of smaller trade sizes, lower overall volumes, and difficulty executing risk-transfer trades. We noted meaningful differences between on-the-runs, (which are similar in liquidity and volume to swaps and Treasury futures), first off-the-runs, further off-the-runs, and other Treasury products such as TIPS, STRIPS, and Bills (which have some liquidity and volume characteristics more in common with corporates and certain segments of the MBS market).

The Committee debated the pros and cons of additional transparency in the Treasury market. Some felt that additional transparency would level the playing field for smaller firms. Others felt that substantial technical expertise and significant computing power would be required to process the data (similar to the Swaps Data Repository) and thus only sophisticated and technologically advanced market participants would benefit.

On-the-run prices, even absent transaction-level dissemination from TRACE, are quite transparent and maintain very tight bid/ask spreads. Most members did not see a need for additional dissemination in this sector but acknowledged the risks here were also small and thus did not object to appropriately calibrated on-the-run trade dissemination. Lessons from both the swaps and futures market would suggest using caps on reported sizes, delays on reporting block trades, and setting cap sizes across the curve based on duration equivalents.

The presenters laid out several key performance indicators (KPIs) which should be monitored to assess the impact of on-the-run dissemination, such as average trade size, market depth,

bid/ask spreads and overall trading volumes. These KPIs should be considered alongside qualitative feedback from market participants on their observation of liquidity. A few members supported dissemination for off-the-runs alongside on-the-runs arguing that transparency might improve liquidity in times of stress. A majority of Committee members expected the effect of transparency during stress to be a net inhibitor of risk intermediation. As such, we recommend allowing time for observation and assessment of the impact to on-the-runs before considering other sectors.

Finally, the group felt strongly that any changes which could impact Treasury market liquidity should be assessed for their interactions with one another before being implemented. Several proposals for the Treasury market have been identified by the official sector and outside groups, including increased transparency, mandatory clearing, changes to dealer registration, and changes to prudential requirements. Each of these will likely influence market functioning and should be viewed holistically.

The Committee then discussed the financing recommendations for the current and subsequent quarter. Near-term deficit estimates have increased somewhat, but the T-bill share of outstanding debt is expected to remain near the lower end of the Committee's recommended range. Primary dealer projections for issuance are reasonably consistent for FY 2023, though they vary significantly for FY 2024 given varied expectations on economic growth and the timing for SOMA run-off. The Committee recommends maintaining auction sizes at current levels for this quarter and next. The Committee also recommends \$1 billion increases in 5-year TIPS reopening in December.

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 financing 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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Deirdre Dunn

Vice Chair, Treasury Borrowing Advisory Committee