U.S. DEPARTMENT OF THE TREASURY

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

February 1, 2023

January 31, 2023

Letter to the Secretary

Dear Madam Secretary:

GDP rose at a 2.9% annualized rate in the fourth quarter of 2022, reflecting a softer 0.8% growth rate of final sales to domestic purchasers, but a large 1.5pp boost from inventory accumulation. Consumption grew at a 2.1% rate, residential investment declined at a 26.7% rate as higher mortgage rates continued to depress housing activity, and business investment rose at a 0.7% rate. Recent signals on economic activity have been more mixed, however, with business survey data generally coming in weaker than hard data in recent months.

The labor market remains tight. Monthly payroll employment gains slowed to 247,000 and household employment gains averaged 131,000 in the fourth quarter, both still well above estimates of the trend pace of labor force growth. Job openings were little changed and remain more than 3 million above the pre-pandemic level. The unemployment rate remained unchanged at its pre-pandemic rate of 3.5%. Both weekly jobless claims and the layoff rate remained very low, though a recent wave of layoff announcements, especially in the technology sector, suggests that the layoff rate is likely to rise at least modestly. The labor force participation rate remained at 62.3% and is now close to estimates of its pre-pandemic trend implied by demographic changes, though average hours worked have declined somewhat.

Wage growth showed early signs of cooling off in the fourth quarter but remains above estimates of the pace compatible with 2% inflation. Average hourly earnings continued to decelerate, and the Atlanta Federal Reserve Bank’s wage growth tracker fell in December.

Core CPI inflation averaged 3.1% annualized from September to December and core PCE inflation averaged 2.9%, both down sharply from the first three quarters of 2022. The deceleration has been led by goods categories, where supply chain recovery and normalizing demand patterns brought a long-awaited deflationary impulse, especially in the automobile sector. Shelter inflation remained hot in the official data, but leading indicators of new tenant rent inflation from alternative data sources indicate that market rents have leveled off. Food inflation decelerated and energy prices fell, keeping headline inflation near 2% in the fourth quarter. Year-ahead consumer inflation expectations fell further and are now substantially below their early-2022 highs but still well above pre-pandemic levels. Longer-term inflation expectations remain at levels generally viewed as consistent with the Federal Reserve's inflation target.

The Federal Reserve delivered a fourth 75bp interest rate hike in November and a 50bp hike in December and is expected to slow the pace again to 25bp in February, raising the target range for the funds rate to 4.5-4.75%. The median projection from the FOMC's Summary of Economic Projections implies two additional 25bp hikes.

Despite the better inflation news, most economic forecasters continue to expect a recession this year. The median forecaster in a January Wall Street Journal survey saw a 65% chance of recession over the next 12 months, little changed from the last survey in October. Many forecasters fear that the large hikes delivered last year will hit the economy with a lag in 2023.

Since the last refunding, financial conditions have eased meaningfully. The GS Financial Conditions Index is 87bps lower with equity prices 4% higher and the trade-weighted dollar 8% weaker. The 2-year Treasury yield fell 22ps to 4.20% and the 10-year yield fell 52bps to 3.51% mainly in response to better inflation news and the shift to a slower pace of rate hikes. Primary credit markets are improving, with investment grade and high yield spreads narrower, though issuance by lower rated credits remains subdued.

In light of this financial and economic backdrop, the Committee reviewed Treasury's February 2023 Quarterly Refunding Presentation. Based on the marketable borrowing estimates published on January 30, Treasury currently expects privately-held net marketable borrowing of $932 billion in Q2 FY 2023 (Q1 CY 2023), with an assumed end-of-March cash balance of $500 billion. The borrowing estimate is higher than at the November refunding, primarily due to a lower starting cash balance and changes in projections of fiscal activity. For Q3 FY 2023 (Q2 CY 2023), privately-held net marketable borrowing is expected to be $278 billion, with a cash balance of $550 billion assumed at the end of June. The end-of-March and end-of-June cash balances assume enactment of a debt limit suspension or increase.

Treasury is, once again, employing extraordinary measures to comply with the statutory debt limit. These measures will only last for a short and uncertain window, which is unlikely to expire before early June. Previous efforts to comply with the debt limit drove the outstanding stock of bills and Treasury's cash balance down to undesirable levels. Abrupt declines in bills outstanding, reductions in cash balances below Treasury's prudent policy level, and any broader uncertainty about Treasury's financing capacity are detrimental to the Treasury market and should be avoided. As Secretaries of the Treasury from both parties noted during the 2021 episode, "It would be very damaging to undermine trust in the full faith and credit of United States."[1] Discussions of fiscal responsibility are more appropriately considered when making appropriations rather than when financing previously approved appropriations. The Committee strongly believes that Congress needs to raise or suspend the debt limit with all due haste. Failing to do so is a reckless and inappropriate approach to managing fiscal policy and may jeopardize Treasury market functioning and increase costs to the taxpayer.

Our one charge was reviewing potential design of a regular and predictable Treasury buyback program to improve cash management and support liquidity. The presenters outlined several principles to guide the design of a buyback program in addition to the objectives above, including: do not materially alter the maturity structure of debt, be accretive to the taxpayer, and move gradually with thorough analysis. The presenters also highlighted that while Treasury buybacks should support overall market functioning, they were not intended to mitigate episodes of acute market stress. Designing a buyback program is complex, as it requires myriad operational, analytical and market judgements. Treasury should carefully consider many of the issues noted below before deciding to move forward.

As a cash management tool, buybacks could facilitate the management of Treasury's cash position amid volatile outlays and receipts. For example, the short coupon sector (<1yr maturity) usually trades at higher yields than similar maturity bills. The Committee agreed this presented a nice opportunity to enhance liquidity at the short end of the curve and provide enhanced supply of relatively more attractive bills. The Committee agreed that short end buybacks could provide a beneficial cash management tool to be used on an as-needed basis.

As a tool for overall liquidity support, a buyback program could provide direct liquidity to specific securities and sectors, but the ultimate liquidity benefit should be enhanced overall market functioning. In keeping with Treasury's regular and predictable approach, buybacks could be announced as part of the quarterly refunding. The Committee agreed that if Treasury moves forward with buybacks, it should retain some flexibility on sizing purchases in line with the attractiveness of offers presented and that this would not be at odds with their regular and predictable issuance framework.

Sizing for a buyback program could be complex and would likely need to be dynamic based on market conditions and Treasury's financing needs. In the extremes, a program should be at least large enough to have some observable impact on liquidity conditions or cash management. Similarly, a program should not be so large as to overwhelm new issue demand and materially erode the on-the-run liquidity premium.

Treasury could monitor several quantitative and qualitative measures to assess the impact of a potential buyback program on overall market functioning including bid/offer spreads, auction tails, trading volumes, and dispersion of off the run spreads. Several macro liquidity drivers could be used to control for non-buyback related effects.

Overall, the Committee agreed that a buyback program could have notable benefits for taxpayers, Treasury, and Treasury market functioning. We recommend that if Treasury moves forward with a buyback program that it start small and expand cautiously. Additionally, any program should be undertaken deliberately and dynamically with frequent monitoring of the impact to ensure Treasury's objectives are being met.

The Committee then discussed the financing recommendations for the current and subsequent quarter. Near-term deficit estimates have increased somewhat, and the T-bill share of outstanding debt is expected to rise within the Committee's recommended range. Primary dealer projections for issuance are reasonably consistent for FY 2023, though they vary significantly for FY 2024 given uncertainty of economic growth expectations and the duration of SOMA run-off. The Committee recommends that Treasury maintain nominal auction sizes at current levels for this quarter and address any financing gaps through increased bill issuance. The Committee also recommends a $1 billion increase in the 5-year TIPS new issue in April as a means of gradually increasing the TIPS share of outstanding debt. Finally, the Committee acknowledged that coupon sizes might need to increase late this year, though the timing is very uncertain.

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 or maintain 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

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[1] https://home.treasury.gov/system/files/136/Former-Treasury-Secretaries-Letter-to-Congressional-Leadership-on-the-Debt-Limit-9-22-21.pdf