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

May 3, 2023

May 2, 2023

Letter to the Secretary

Dear Madam Secretary:

Since the last TBAC meeting, markets have focused on the outlook for US economic growth, inflation, and Fed policy. In March, emergent risks to financial stability increased market attention on downside risks to economic activity and Fed policy rates, provoking extraordinary volatility in short-term Treasury yields. More recently, risks around the debt ceiling have led to some distortions in the T-bill yield curve, and meaningful concessions in some new issuances.

Many private sector investors expect a recession in the next year. The median respondent to the March Federal Reserve Primary Dealer Survey saw a 20% probability a recession would begin in the first half of 2023 and a more than 50% probability that a recession would start before the end of the year.

Despite slowdown concerns, economic activity has continued to expand steadily. Q1 real GDP growth registered 1.1%QoQ annualized. Final private sales to domestic purchasers were up a strong 2.9% supported by a 3.7% annualized increase in consumer spending. Unusually strong activity and jobs data for January (released in February) helped lead 10y Treasury yields above 4.0% in early March, their highest level since November 2022.

The contraction in the housing sector, sometimes viewed as a harbinger of recession, continued but moderated in Q1. Monthly housing data suggest housing activity is no longer declining and may be rising from low levels.

While recent layoff announcements are another potential sign of a coming slowdown, for now the job market remains resilient and tight. Establishment survey payroll increases accelerated to 345k on average in Q1, well-above the about 100k monthly pace of labor force growth. The unemployment rate has returned to its pre-pandemic level of 3.5%. Job openings declined to just below 9.59 million but remain 3-4 million above more historically normal levels and the quit rate is elevated at 2.5%.

Data on wage growth have been mixed. Average hourly earnings slowed in the first quarter to 3.8% annualized, still elevated but approaching rates consistent with 2% inflation. To the contrary, the Atlanta Fed Wage Tracker for March accelerated from 6.1%YoY to 6.4%YoY. The employment cost index advanced 1.2%QoQ, suggesting a pace of wage growth somewhere between these two extremes.

A string of softer core inflation prints in late 2022 led 2y “breakeven” inflation rates implied by TIPS to fall to just above 2.0%. At 4.9% QoQ, annualized core PCE inflation remained well above target in Q1.

Interest rate markets substantially repriced the Fed policy path over the intermeeting period. As activity data for January surged, inflation came in stronger and Fed Chair Powell suggested an upward revision to the terminal policy rate might be appropriate, rates markets priced a terminal policy rate above 5.5%. The outlook for Fed policy shifted dramatically as stress in the banking system emerged in early March, including the second largest bank failure in the history of the US. In the month of March, $496bln flowed out of bank deposits and $378bln flowed into money market mutual funds. The expected terminal rate fell below 5.0% with options market “skew” suggesting more downside than upside risk.

Data and anecdotes suggest the banking stress may make banks more cautious in making loans. The NFIB small business survey for March showed an increase in the percentage of firms seeing less availability of loans. The Q1 Senior Loan Officer’s Survey shows that lending conditions were tightening before the banking stress emerged. The eventual effects of the credit tightening on the US economy remain highly uncertain.

After the Fed raised the policy range by 25bp in March to 4.75-5.00%, rates markets are pricing a high probability of another 25bp hike May 3rd but imply only a modest chance of further hikes and substantial probability of cuts by the end of 2023.

The debt ceiling has become an urgent concern with Treasury’s Monday announcement that cash and extraordinary measures could be exhausted as early as June 1st. T-bills maturing in June are trading cheap to surrounding securities and to the OIS curve, as investors demand a yield premium to hold these issues, increasing costs to the taxpayer.

Treasury’s current cash balance of $238 billion is already well below TBAC recommended levels, Treasury’s own prudent policy level, and significantly below what even the nation’s largest banks hold in available liquidity despite managing significantly smaller balance sheets. Financial markets have been under considerable stress and interest rate markets experienced unprecedented volatility due to three large bank failures over the past 2 months. Uncertainty about Treasury's ability to finance the government is detrimental to the Treasury market, business and consumer confidence, and credit availability, which is already expected to contract.

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 should be considered when making appropriations rather than when financing previously approved budgets. The Committee strongly believes that Congress needs to raise or suspend the debt limit with all due haste. Failing to do so is reckless and is already disrupting Treasury market functioning, increasing costs to the taxpayer, and constraining economic growth.

In light of this financial and economic backdrop, the Committee reviewed Treasury's May 2023 Quarterly Refunding Presentation. Based on the marketable borrowing estimates published on May 1, Treasury currently expects privately-held net marketable borrowing of $726 billion in Q3 FY 2023 (Q2 CY 2023), with an assumed end-of-June cash balance of $550 billion. The borrowing estimate is higher than at the February refunding, primarily due to a lower starting cash balance, projections of lower receipts and higher outlays. For Q4 FY 2023 (Q3 CY 2023), privately-held net marketable borrowing is expected to be $733 billion, with a cash balance of $600 billion assumed at the end of September. The end-of-June and end-of-September cash balances assume enactment of a debt limit suspension or increase.

We next discussed Treasury's current views on buybacks as a policy tool. The Committee recognizes there are still several issues for further consideration but is supportive of the current outline and supports Treasury enhancing its debt management toolset. We acknowledge that the proposed sizing (up to $240 billion per year across liquidity support and cash management) should be meaningful to market participants but would be small in the context of Treasury's financing needs and would not materially impact Treasury's duration profile. Treasury should design any buyback program in a regular and predictable manner, by transparently communicating frequency and target sizes but should also maintain execution flexibility in both pricing and sizing. The Committee agrees that the program should not be used to mitigate episodes of acute market stress.

Our first charge examined potential changes to the auction calendar to consolidate issuance by shifting 2-, 3-, 5-, and 7- year notes from monthly new issues to one new issue and two reopenings each per quarter. These changes would have a meaningful impact on the number of CUSIPs outstanding, potentially reducing the number of issues by more than half over time. The group expects that concentrating issuance into fewer CUSIPs will enhance balance sheet efficiency and may improve Treasury market functioning. There was some concern about how such large issue sizes would perform as they age. Consolidation benefits in the front end, notably for 2yr notes, should be weighed against maintaining granularity at the front end of the curve. Overall, the group believes this change could improve market liquidity, but would benefit from further study. Specifically, more analysis is needed on impacts during a transition period and whether turnover would scale proportionally with issue sizes.

The second charge was on the appropriate size of TIPS issuance and share of outstanding debt. TIPS are a useful tool for Treasury as they tend to offset likely higher deficits in periods of low inflation and provide diversification benefits to investors. Market pricing of inflation and trading activity suggest demand could support increased issuance. Growth in TIPS funds has kept pace with supply and international investors continue to support the asset class. Absent increases in new issues, TIPS share would decline further given expected increases in nominal supply and large upcoming TIPS maturities. The Committee recommends Treasury begin increases to TIPS particularly in the front end at the next new issuance for each maturity point, but closely monitor market performance to ensure the supply is being well received. The Committee also recommends further study on the mix of TIPS issuance, the possibility of increasing the number of issues per year, and potential support for an additional front-end point.

The Committee then discussed the financing recommendations for the current and subsequent quarter. Near-term deficit estimates have increased, and the T-bill share of outstanding debt is expected to rise above the top of the Committee's recommended range. Primary dealer projections for issuance have increased for FY 2023 and vary significantly for FY 2024 given uncertainty of economic growth expectations and the duration of SOMA run-off. The Committee debated whether to raise coupon sizes this quarter but recommends that Treasury maintain auction sizes at current levels for this quarter. However, given latest deficit estimates the Committee expects coupon sizes will need to increase as soon as next quarter.

The Committee discussed where increases should be concentrated when the need arises. The group generally expects all coupon sizes will need to increase but favored increasing both TIPS and nominal coupons across the curve though slightly less in 7- and 20- years.

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. Given the scale of the changes in forecasted borrowing needs, it is likely that key debt characteristics will deviate from TBAC recommended ranges. Notably, we expect the T-bill share of outstanding debt to temporarily exceed 20% at or before FY2024. This increased T-bill supply is likely to be well received by investors. However, we suggest Treasury return T-bill share to the recommended range over time to maintain flexibility in case of a recession.

Over a longer horizon, we encourage Treasury to maintain the high average maturity of its debt and to arrest the decline of 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.

As this is my final meeting with the Committee concluding 8 years of service, 5 of which were as Chair, I want to thank you and your team for your partnership and continued support of TBAC. I have served alongside 39 different members and am enormously proud of each of their contributions. In my time on the Committee under 3 different Secretaries, with 3 different Vice-Chairs, we have advised Treasury on numerous challenges including 2 years of virtual meetings, how to accommodate the surge in funding through COVID, and introduced 3 new products (2-month bills, 4- month bills and 20- year bonds). We improved transparency in TBAC tools by releasing code for both the Optimal Debt Model and the Financing tables to the public in partnership with Brookings. The Committee maintains a robust agenda ahead including the 6th debt limit episode in those 8 years, rising deficits and an uncertain economic environment. I have every confidence Deirdre Dunn and Colin Teichholtz, as incoming Chair and Vice-Chair will be outstanding leaders of this Committee's important work.

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