REPORT TO THE SECRETARY OF THE TREASURY
FROM THE

TREASURY BORROWING ADVISORY COMMITTEE OF THE BOND MARKET ASSOCIATION

August 3, 2004

Dear Mr. Secretary:

The economy has slowed since the Committee's last meeting in May, as the surge in energy prices since last winter has cut into household purchasing power and restrained consumer spending. The advance report on 2Q real GDP shows growth slowing to a 3.0% pace from a 4.5% growth pace in 1Q. Real consumer spending slowed to a 1.0% pace while other private-sector spending – business fixed investment, housing, and exports – each accelerated in 2Q. It appears that growth is rebounding this quarter despite the further increase in the price of oil. Supply-side manufacturing and housing surveys in hand for July are at elevated levels consistent with vibrant economic expansion. And demand-side indicators of household demand for July (including a better tone to the reports from retailers and automakers and improved consumer confidence readings) point to stronger growth of consumer spending.

Core inflation as measured by the core PCE price index has accelerated from 1.2% in 2003 (q4/q4) to 2.1% at an annual rate in 2004 1Q and a 1.8% rate in 2Q. The near-term outlook for core inflation is mixed. The slowdown in consumer spending and outlook for increased discounting, points to some moderation, while the latest business surveys generally point to more extensive price increases.

The Treasury market was mixed over the past three months – rates initially continued to rise as market participants digested strong economic data, but then rallied back after data weakened somewhat. Over the last three months, 2-year yields have risen 33bp while 10-year yields have fallen 10bp, and the yield curve has flattened 48bp. Currently, the market is fully pricing in a 25bp tightening at the August 10th FOMC meeting and cumulatively 80bp of tightening by year-end.

With about 80% of the S&P 500 firms having reported, second-quarter earnings are meeting expectations of $16.68 per share. This figure is 24.6% higher than year ago earnings per share. However, with the economic expansion now incorporating meaningful job growth, labor expense has accelerated and profit growth appears to be slowing. Broad measures of stock market performance were flat during 2Q but have declined nearly 5% so far in 3Q, with losses especially pronounced for tech stocks. Recent losses seem to reflect concerns about the effects that higher oil prices will have on an economy that is already slowing, but some may also reflect political uncertainties related to the November election.

The real trade-weighted dollar has appreciated 2.6% since the end of the first quarter. Currency appreciation seems to reflect the prospect for significant Fed tightening over the next year. The dollar has appreciated against both the yen and the euro.

Federal budget performance over the last few months was stronger than expected, mainly reflecting upside surprises on income growth and associated tax revenues. Consequently, over the past three months, many analysts have lowered forecasts of the budget deficit by roughly $50 billion for both this year and next year, which is generally consistent with official estimates as well.

Against this economic and financial backdrop, the members of the Committee began consideration of debt management questions in the Quarterly Charge. Following their standard format, Treasury presented a chart package for discussion that will be released as part of the Treasury refunding announcement.

The first part of the Charge asked the Committee for its view on reducing marketable issuance in the face of a declining financing need and the impact of such reduction on market liquidity. In their presentation, Treasury made several points. They felt issuance could easily be raised, but a reduction in issuance would be more difficult for the markets. One of the factors for them to be mindful of is current liquidity conditions in the markets. Additionally, Treasury was clear that they relied heavily on the bill market to handle much of their financing need. Maintaining a robust bill market is critical to Treasury's daily market operations. In order to retain the flexibility that bills afford them, Treasury asked Committee members if they were to keep bill issuance static, could they reduce coupon issuance in an environment where they are managing to a favorable deficit forecast.

Several Committee members suggested that Treasury needs to be concerned with this issue, and emphasized the need for a liquid coupon curve and repo market. There was more interest in maintaining current issuance levels in the 5-year and 10-year maturities versus the 2-year and 3-year maturity sectors of the coupon curve. The longer sectors were considered to be more critical to the market at this juncture, whether used as investment vehicles or as hedging vehicles. There was discussion of the 10-year maturity sector as to whether there was a need to consider the elimination of the 10-year note reopening. The Committee felt that this was not necessary at this point in time. Some members of the Committee felt there could be problems associated with reducing issuance in certain sectors if market participants were not certain of their ability to borrow issues freely. The Committee suggested that Treasury should work to insure that foreign holders lend securities more readily. Treasury was encouraged to add more transparency to the types of buyers of securities and to develop a repo facility to balance market-driven shortages in securities. One member expressed concern with the shortening of the average maturity of the debt. Consensus from the Committee was that the raised issuance in 5-year, 10-year and TIPS securities has compensated for this over the past year. The Committee concluded the first part of the Charge by suggesting that Treasury can reduce issuance along the coupon curve provided they work with market participants to maintain a transparent and robust repo market.

The Committee then took up the second part of the Charge. In it, Treasury asked the Committee to discuss slides that could help illustrate a variety of risks to forecast, given different outcomes for inflation, interest rates and fiscal balances. Treasury presented a slide which introduced scenarios for budget deficits and surpluses in coming years based on forecast deviations experienced over the past 15 years. Similarly, Treasury presented charts showing various interest rate levels and inflation rates. Treasury then developed the risk scenarios by illustrating the impact of modeled outcomes on interest expense nominally and in relation to outlays. Treasury noted that their presentation of the slides was meant to be an initial effort to prompt discussions and that the slides are overly simplified by design.

Committee members noted the over simplified nature of the scenarios, but felt in general that the effort to discuss the scenarios was an important step for Treasury to take. Members differed as to whether Treasury should include scenarios based upon inflation forecasts. Some stated they were implicitly captured in interest rate scenarios. Others felt that inflation should be included as an important single variable to consider when assessing risks. Some members felt that limiting scenarios to short time frames, two or three years, would make them more illustrative than longer scenarios where complex interplay of the variables can lead to faulted conclusions. In general, most members felt that Treasury had isolated the correct variables to include in future risk scenario analyses. The Committee agreed to work with Treasury on an ongoing basis, further developing models which are accurate representations of potential risk outcomes.

In the third part of the Charge, Treasury asked for the Committee to share its views on the growing participation of foreign investors in the U.S. Treasury market. Treasury stated its belief that foreign participation lowers borrowing costs and reflects confidence of external lenders in the United States. Treasury presented a slide showing increasing percentages of Treasuries held abroad in relation to total privately held public debt.

The Committee noted the strength of the trend illustrated in the slide. Most felt that though the trend may well moderate, it was unlikely to reverse soon. The members stated that foreign participants in the U.S. Treasury market were likely to continue to invest a large portion of their current account surpluses in assets of superior credit quality and liquidity. Some members stated that as foreign participants become increasingly large holders of U.S. Treasuries, it will be important to ensure their participation in repo markets. These members expressed concerns that the markets could potentially be disrupted without this important change in foreign investor participation. Members strongly encouraged Treasury to actively further this discussion with participants in Asia, where accumulation of official reserves has been rapid in recent years. Members also noted the beneficial impact of low sovereign interest rates on other financial assets. In general, members felt that Treasury did not face a meaningful intermediate term risk to steady foreign investments in Treasuries, though most felt it was likely that the current, very rapid pace of U.S. Treasury securities accumulation would abate later in the year.

The Committee then addressed the question of the composition of Treasury notes to refund approximately $28.8 billion of privately held notes and bonds maturing or called on August 15, 2004, as well as the composition of Treasury marketable financing for the remainder of the July-September quarter, including cash management bills and the October-December quarter, including cash management bills. To refund $28.8 billion of privately held notes and bonds maturing August 15, 2004, the Committee recommended a $24 billion 3-year note due 8/15/07, a $15 billion 5-year note due 8/15/09, and a $15 billion 10-year note due 8/15/14. For the remainder of the quarter, the Committee recommended a $24 billion 2-year note issued in August and a $24 billion 2-year note issued in September, a $15 billion 5-year note issued in September and a $10 billion reopening of the 10-year note in September. The Committee also recommended a $25 billion 12-day cash management bill issued 9/3/04 and maturing 9/15/04. For the October-December quarter, the Committee recommended financing as contained in the attached table. Relevant features include three $24 billion monthly 2-year notes, a $24 billion 3-year note, one $15 billion and 2 $14 billion monthly 5-year notes, a $13 billion 10-year note in November followed by a $8 billion reopening of that 10-year note in December. The Committee further recommended a $14 billion 5-year TIPS for issuance in October as well as a $9 billion reopening of the 7/15/14 10-year TIPS in October.

Respectfully submitted,

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Chairman

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Vice Chairman

Attachments (2)