REPORT TO THE SECRETARY OF THE TREASURY FROM THE TREASURY BORROWING ADVISORY COMMITTEE OF THE BOND MARKET ASSOCIATION

October 31, 2000

Dear Mr. Secretary:

Since the Committeeís last meeting on August 1, the US economy has shown some signs of moderating from the exceptionally strong pace of growth that had been evident in prior quarters. In fact, the Commerce Department recently reported that GDP rose 2.7% in the third quarter ñ compared with the average 6.1% gain recorded in the prior four quarters. Moreover, there have been some signs that the downshift in growth may be sustained. Specifically, corporate earnings expectations have been lowered as a number of large companies have issued warnings that profit expectations may be too optimistic. Indeed, a number of factors are likely to contribute to some slowing in the economyís forward momentum, including higher energy prices, the lagged effect of Fed tightening and a strengthening dollar. The potential for some aftershocks associated with the downshift in the US growth engine ñ such as pressure on equity markets, a slackening in capital spending as corporate cash flow decelerates, and a widening in credit spreads as lenders demand greater compensation for risk ñ could magnify the downside for the overall economy.

On the inflation front, higher oil prices have helped push up headline readings for CPI and PPI in recent months. Meanwhile, core inflation continues to show a modest gradual acceleration. The CPI excluding food, energy and tobacco is running at a 2.5% pace ñ nearly a full percentage point above the trough that was hit in the second half of 1999. Finally labor markets remain very tight, and employment costs appear to be trending a bit higher, although productivity is expanding at a very rapid rate, which is helping to keep a lid on overall unit labor costs.

For the most part, Treasury yields have trended lower over the past three months. For example, the yield on 2-year Treasury notes was slightly above 6-1/4% at the time of the August refunding while the yield on the 10-year note was hovering right around 6%. Today these instruments yield about 30 basis points less than they did in early August. In contrast to the rally that has been evident across most of the Treasury curve, the yield on 30-year bonds has dipped only a few basis points during the past few months.

A shift in expectations regarding the future course of Fed policy together with nervousness about the prospects for equity markets has helped fuel the rally in Treasuries. Indeed, at one point a couple of weeks ago, the S&P 500 was down more than 7% relative to the level that had prevailed at the time of the Committeeís last meeting. And, the bulk of the yield decline in Treasuries that has occurred over this period has tended to coincide with the downdrafts in the stock market. In recent days, the S&P investment grade index (which reflects the spread between high grade corporate bonds and a Treasury benchmark) hit its widest level since October 1998. Moreover, the S&P high yield index has widened from about 675 bp over Treasuries in early August to 860 bp in late October.

Against this backdrop, the Committee considered the composition of a financing to refund $23.9 billion of privately held notes maturing on November 15 and to pay down approximately $4 billion of debt.

The Committee unanimously recommends a total financing of $20 billion consisting of the following offerings:

- $12 billion of 5-year notes due November 15, 2005,
- $8 billion reopening of the 10-year notes due August 15, 2010

In regard to the composition of Treasury market financing for the remainder of the current quarter, the Committee recommends that the Treasury meet its requirement in the following manner:

- A 2-year note of $10 billion,
- A 1-year bill of $10 billion,
- Weekly issuance of 3- and 6 month bills through the remainder of the quarter,
- A cash management bill totaling $22 billion to mature during the quarter, and
- and Buybacks totaling $4.75 billion.

For the January-March quarter, the Treasury estimates a net market borrowing requirement of $20 billion with a cash balance target of $30 billion on March 31. To accomplish this requirement, the Committee preliminarily recommends the financing schedule in the attached table.

This recommendation includes a proposed elimination of the one-year bill offering, consistent with the Committeeís past views and the Treasuryís stated intentions. The recommended level of debt buybacks for the first quarter is $8.5 billion.

At the Treasuryís request, the Committee considered whether it would recommend any further changes in FY 2001 to auction frequencies or cycles in light of continued government and private forecasts of higher surpluses. The Committee reiterated its view on its prioritization of changes to the current financing schedule that should be considered over future quarters. The Committee continues to feel that a reduction in frequency of 2-year note offerings should be the next reduction considered by the Treasury, once the 1-year bill elimination has occurred. The Committee continues to feel that further reductions in the frequency and size of inflation-indexed securities should be considered, in light of the significant amount of cash being raised by these offerings. In addition, a consideration of changes in this period of large surpluses needs to include the possible elimination of the 30-year bond, particularly in the context of a gradual lengthening of the average maturity of the debt.

Committee members believe that the buyback program to date has been successfully executed. Members reemphasized the importance of the program as a debt management tool that gives the Treasury considerable flexibility as it considers and executes further changes in the auction calendar. The Committee believes that the market could absorb a larger level of debt buybacks. In addition, the Committee expressed its support for a policy of pre-announcing the expected total amount of buybacks for the upcoming calendar quarter at the time of the quarterly refunding announcements. This will reduce the amount of uncertainty and market volatility associated with the program.

Under current Treasury auction procedures, the so-called ì35-percent ruleî limits the sum of a bidderís net long position plus competitive award to 35 percent of a Treasury auction. In the case of a reopening, holdings of the outstanding security are counted toward the limit in the calculation of the net long position, while the calculation of the dollar amount of the limit is only based on the announced reopening size. In its current form, the inconsistency of this rule has adversely affected the ability of certain market participants to bid in Treasury reopening auctions. With the Treasury having moved to a regularized schedule of reopenings of Treasury securities, the rule over time could result in weaker auction coverage and potentially higher borrowing costs. As a result, the Treasury asked for the committeeís recommendation on a possible change to this rule. The Committee recommends that the 35 percent rule be altered so that the net long position used in the calculation of a bidderís position refer only to the position in the when-issued security. This would make the calculation of the bidderís net long position plus competitive award consistent with the calculation of the 35 percent limit.

Respectfully submitted,

Kenneth M. deRegt