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

August 4, 1998

Dear Mr. Secretary:

Since the Committee's last meeting on May 6, 1998, the economy has continued to perform quite well. Indeed, while the Commerce Department recently reported that GDP expanded at only a 1.4% pace in the second quarter, this was above consensus expectations and comes on the heels of a 5.5% surge in Q1. Benchmark revisions added about 0.4 percentage point annually to the already impressive GDP growth figures recorded over the prior three years. To be sure, there are some signs that activity in the manufacturing sector moderated in recent months, as the strength of the dollar and a downshift in the economies of some of our trading partners has helped to dampen demand for US exports. From a broader perspective, consumer-led demand strength, gains in construction activity, and rebound in business capital spending have thus far offset the weakness in the trade sector arising from the financial crisis in Asia.

On the inflation front, the news remains generally favorable. A spike in quotes for tobacco products has led to some elevation in PPI and CPI readings during the past few months, but, excluding this special factor, there has been little sign of any acceleration in prices of core goods and services. Indeed, quotes for energy items and other industrial commodities remain quite low by historical standards and prices of non-fuel imported goods continue to post significant declines. Meanwhile, available evidence suggests that labor markets remain very tight, and the recently released employment cost index report provided some evidence that wage and benefit costs are trending higher. However, this process appears to be evolving very slowly.

Yields on Treasury issues are 15 to 35 basis points lower than at the time of the Committee's last meeting. The bulk of the decline in yields occurred during a period of significant appreciation of the dollar in late May and early June. Yields have been fairly steady since mid-June. Forward rates reflect a strong market consensus that monetary policy will remain stable over the next several months.

Within this context, to refund $27.8 billion of privately held notes maturing on August 15, 1998 and to raise $9.2 billion of new cash, the Committee recommends that the Treasury auction $37.0 billion of the following securities:

· $16.0 billion 5-year notes due August 15, 2003

· $11.0 billion re-opened 5-5/8 percent notes due May 15, 2008

· $10.0 billion 30-year bonds due August 15, 2028

The Committee recommends, unanimously, a reopening of the 5-5/8% note due May 15, 2008. The Committee continues to feel that re-openings are helpful to market liquidity and reinforce the benchmark status of active issues. In the case of the proposed 5-year note, however, the Committee, again unanimously, voted for a new issue. In this case, the view was that the benefits of additional liquidity were more than offset by the potentially significant cost to the Treasury of combining a new Issue an exceptionally large, outstanding issue which presently trades at a significant yield premium to the existing on-the-run 5-year security.

In its refunding recommendation, the Committee voted, by a 12-6 majority, for a total offering size of $37 billion to reflect the continued improvement in Treasury finances and reduced market borrowing needs. The minority reflected a desire for an offering of $38 billion, in order to reinforce the benchmark status of the proposed offerings. The Committee adopted its recommendation for the proposed composition, by a 13-5 majority, with the view that a slightly larger five-year offering was important to maintaining liquidity in this sector, with the large reduction in supply as a result of the recent financing changes. A slightly smaller 10-year offering was viewed by the majority as acceptable, within the context of the proposed re-opening of the current 10-year note. The minority of Committee members felt a five-year offering of $15 billion was of sufficient size to maintain liquidity and benchmark status, and wanted to maintain the offering sizes in the 10-year sector at $12 billion. All members supported a 30-year bond offering of $10 billion.

With the introduction of the 5-year note to the refunding offerings, the Committee feels that the resolution of the issue of auction format has become more important, given the fact that the 5-year has been sold in recent years under the single-price format, while the 10-year and 30-year securities have been auctioned with a multiple-price format. The Committee understands that the Treasury is in the process of completing its study of this issue, and, in our view, a resolution of this issue prior to the next quarterly refunding would be desirable.

The Committee recommends that for the remainder of the quarter, the Treasury meet its borrowing requirement in the following manner:

· Two 2-year notes of $15.0 billion each,

· Two 1-year bills of $10.0 billion each,

· Weekly issuance of $13.0 billion of 3- and 6-month bills through the remainder of the quarter, and a

· Cash management bill of $32 billion, maturing within the quarter.

The proposed offering schedule, along with estimated foreign add-one of $10.5 billion will meet the estimated Treasury market borrowing requirement of a $45 billion paydown.

For the fourth quarter of 1998, the Treasury estimates a market borrowing requirement of $10 to $15 billion. To accomplish this requirement, the Committee recommends the provisional financing schedule in the attached table.

At the Treasury's request, the Committee considered alternatives for further changes in Treasury market financing in light of the further improvement in the govemment's fiscal position. In considering this request, the Committee noted that the extensive changes in the frequency and size of regular Treasury coupon offerings, which were announced at the time of the last quarterly refunding, anticipated an extended period of sizable net paydowns in outstanding marketable Treasury debt. While there has been some additional improvement in the current fiscal position and near term outlook since then, there was a consensus among the Committee that there was no near term need to consider implementing significant further changes at this time.

Looking further ahead, and in the event that the size of projected net paydowns were to Increase significantly from recent estimates, the Committee considered a number of longer term possible modifications to the recently introduced cycle of offerings. In this regard, the Committee strongly reaffirmed its support for the general objectives of moving to less frequent larger coupon offerings, in order to preserve liquid benchmark issues, and to modest increases in regular bill offerings, to help reliquify that segment of the market. With those general objectives in mind, the Committee discussed two possible further modifications to the new coupon offering cycle. One alternative would be to reduce from three to two the number of 30-year bond offerings. The other would be to shift from twelve annual offerings of 2-year notes to 8 larger offerings of those notes**C**in months other than those of quarterly refundings**C**with some net shift in issuance from the two year sector into both bills and longer term quarterly coupons.

The later alternative was seen as building on the existing strategy and very consistent with achieving the general objectives of how to adapt debt management practices to the improved fiscal environment. To the extent further changes in the issuance cycle were needed**C**and as of now that is not the case**C**this alternative was strongly preferred by the Committee relative to any further reduction in the size or frequency of the benchmark quarterly refunding issues.

The Committee next considered a series of questions regarding the upcoming cycle of inflation indexed securities. In evaluating experience to date with this program, the Committee was unanimous in the view that future cycles of these securities should be limited to 10- and 30-year offerings**C**where investor demand is greatest**C**with a discontinuation of new 5-year inflation linked securities. The Committee was also strongly of the view that the Treasury could now build on its experience to regularize the issuance calendar for these securities, as it has done for its regular offerings of nominal debt. In this regard, the Committee generally supported the view that, beginning with the January 1999 offering, the Treasury should offer an alternating calendar of 10- and 30-year inflation linked securities, thus positioning the 30-year offerings in the calendar quarter for which there is no nominal 30-year bond issue. This alternating calendar was felt to be the best way to tap into the somewhat different investor pools interested in these two maturities, while still preserving opportunities to re-open existing issues of these securities so as to somewhat enhance liquidity.

In terms of the appropriate maturity for the October 1998 offering, the Committee was divided in its views with the majority preferring a new 10-year IIS which could then be re-opened in January. This was felt to be most in line with market expectations and would re-open that segment of the market following two prior 30-year offerings. The minority felt that demand was strongest in the 30-year sector and that a 30-year offering in October would begin immediately with the alternating regular calendar being recommended for 1999.

Finally, the Committee considered questions relating to the timing of announcements of regular bill offerings and the length of the when issued trading periods for those offerings. In this regard, it was noted that the typical existing WI periods for weekly offerings was seven weekdays, and for the monthly 52-week bill offering, it was nine weekdays. Both periods were felt to be somewhat longer than was needed for distribution and price discovery and it was noted that a somewhat shorter period would provide the Treasury with more time and additional information on short-term cash flows to fine tune the size of these offerings. Based on these considerations, it was felt that the market could easily adjust to a standard, shorter cycle with all bill announcements on Thursday, with weekly 13-week and 26-week bill auctions remaining on Monday, with the monthly 52-week bill auction moving to Tuesday, and with all bill auctions settling on the Thursday immediately following auction days. The practical effect of this would be to shorten and standardize the WI periods for all regular bill offerings.

Respectfully submitted,

Stephen G. Thieke
Chairman