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

August 2, 2000

Dear Mr. Secretary:

Since the Committee's last meeting on May 3, the US economy has remained quite strong, with the Commerce Department recently reporting that GDP posted a 5.2% annualized growth rate in the second quarter. Over the past year, the GDP has expanded at a 6% pace. While there have been some signs of moderation in consumer demand, business capital spending remains extremely strong, and the global economy appears to be on the upswing, which could eventually provide a boost to US exports.

On the inflation front, higher oil prices have helped push up CPI and PPI in recent months. However, quotes for energy-related items appear to have peaked at this point, so headline readings should be somewhat better behaved going forward. Meanwhile, core inflation continues to show a very modest gradual acceleration. The CPI excluding food, energy and tobacco is running at a 2.2% pace – about 0.5 percentage points 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, but productivity is expanding at a very rapid rate, which is helping to keep a lid on overall unit labor costs.

Since the FOMC announced a 50 basis point rate hike on May 16 – two weeks after our last meeting – Treasury yields have trended lower. This move appeared to largely reflect an expectation that the economy was cooling and future Fed tightening would be limited. The federal funds futures market now appears to be pricing in about a 30% chance of a 25bp rate hike at the August 22 FOMC meeting. The rally in the Treasury market during the past few months has been evident across the spectrum of maturities. The yield on 2-year Treasury notes has dipped about 60 bp since the May rate hike. Yields on longer-term maturities have declined almost as much over the same interval. Announcements of upward revisions to long-run official budget surplus forecasts in recent weeks seemed to reinforce the market's focus on dwindling Treasury supply.

Although there has continued to be high levels of credit market volatility and spread levels are still significantly wider than at the start of the year, spread levels for most investment grade fixed income markets are currently close to the levels that prevailed at the time of our last meeting.

Against this backdrop, the Committee considered the composition of a financing to refund $25.1 billion of privately held notes maturing on August 15, and to pay down approximately $100 million of cash.

The Committee unanimously recommends a total financing of $25 billion consisting of the following offerings:

- $10 billion of the 6-3/4% note due May 15, 2005,
- $10 billion of 10-year notes due August 15, 2010, and
- $5 billion of the 6-1/4% bond due February 15, 2030.

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 $10.0 billion,
- A 1-year bill of $10.0 billion,
- Weekly issuance of 3- and 6-month bills through the remainder of the quarter,
- Two cash management bills totaling $45 billion to mature during the quarter, and
- Buybacks totaling $3.5 billion.

For the October-December quarter, the Treasury estimates a net market paydown of $10 billion with a cash balance target of $30 billion on December 31. To accomplish this requirement, the Committee preliminarily recommends the financing schedule in the attached table.

At the Treasury's request, the Committee reviewed the current status of the buyback program, updating its views based on the experience of the ten operations that have already been executed. The operations to date have run smoothly, with minimal market disruption. The announcement in May by the Treasury that buyback operations would take place on the third and fourth Thursdays of the month over the next three months helped regularize the operations and reduce market uncertainty. The Committee reiterated its support for the announcement of a quarterly schedule and suggested that a target total for the quarter also be included in the announcement. The one-day notice period for each specific operation accommodates the need to inform potential foreign participants of the specifics of each operation. The Committee continues to believe that for any given operation, a two to five year range of maturities is preferable, with the specific size of the range depending on the size of the operation. Although cover ratios for the operations have been at comfortable levels so far, the Committee expressed the view that at some point the willingness to offer securities to the Treasury in the 15 to 25 year maturity range will begin to fall off, and ultimately be exhausted. The Committee suggested that the Treasury continue to monitor investor participation closely, and be willing to consider buying callable securities and issues outside the 15 to 25 year maturity range at an appropriate time in the future.

Since the Committee last convened, the Administration's Midsession Review and CBO's Budget Update were released showing significantly higher surpluses and greater debt reduction than was projected earlier this year. The Committee considered whether it would recommend any further changes to the Treasury's financing plans as a result of these new projections.

While acknowledging that increasing surplus projections had raised anxiety over the future of long-term debt offerings generally, and the 30-year bond offering specifically, the Committee sees no immediate need to make further changes to the Treasury's financing schedule. It would be helpful to all market participants for Treasury to clarify its view on the future role of long-term government debt. However, this clarification needs to be made within the context of potential fiscal policy changes and an assessment of the value of maintaining a liquid government yield curve in a period of sustained surpluses.

Finally, the Treasury sought the Committee's views on the desirability of allowing for the stripping of outstanding 5-year notes issued prior to September 1997. In September of 1997, the Treasury announced that all new marketable fixed rate coupons would be eligible for stripping. Securities issued prior to 1997 that were not already eligible for stripping were not made eligible. At present, this specifically means that 5-year notes issued prior to 1997 are not eligible for stripping. The Committee suggested that making these issues eligible for stripping would enhance market liquidity in the shorter dated zero coupon sector. The Committee went on to suggest that in an environment in which the Treasury is buying back longer term debt, any effort to improve zero coupon liquidity would enhance market participants' efforts to reconstitute longer dated issues and increase the potential pool of debt that could be offered in the buyback program. In that context, Committee members recommended that the Treasury consider making coupon and principal strips fungible, recognizing that there may be technical debt accounting and tax issues that have to be resolved before such a change could be executed.

Respectfully submitted,

Kenneth M. deRegt