REPORT TO THE SECRETARY OF THE TREASURY
FROM THE TREASURY BORROWING ADVISORY COMMITTEE OF THE
PUBLIC SECURITIES ASSOCIATION

August 1, 1990

Dear Mr. Secretary:

Market yields on U.S. Treasury securities have declined considerably since the last meeting, while the yield curve has assumed a more positive slope. An unwinding of early-year spikes in food and energy prices lent a more favorable tone to recent inflation statistics, and foreign bond markets, other than in Japan, have stabilized following a sharp rise in yields during the first quarter. Market sentiment has also been buoyed by the prospect that negotiations between the Administration and Congress would lead to large, credible reductions in the Federal budget deficit and market borrowing needs. Meanwhile, renewed evidence of softness in business conditions and speculation that financial restructuring could constrain domestic spending created an especially firm tone among short-dated issues, a trend that was further aided by a silent easing of Federal Reserve monetary policy in mid-July. Since early May, 3-year note yields have fallen from 8.93 percent to 8.00 percent, while 10-year note yields have eased to 8.35 percent from 8.96 percent, and 30-year bond yields have gone from 8.95 percent to 8.40 percent. Treasury bill yields have declined somewhat less, however, due to persistently heavy new bill supplies which have been a direct outgrowth of the Resolution Trust Corporation's working capital program.

Prospects for further declines in market yields will depend importantly on the outcome of the ongoing budget negotiations. The resolve that has been expressed by the President and Congressional leaders to reach agreement on a fiscal package has been most encouraging, but the total size and perceived enforceability of any fiscal accord will likely be the key determinants of how the markets respond. While that latest producer and consumer price data have on balance had a calming effect on financial markets, participants remain sensitive to the risk that persistent upward pressures on compensation costs and a downtrend in the dollar exchange rate may be pushing up the underlying rate of inflation. It is against this background that we have produced our recommendations for the August refunding.

The Committee's recommendation on the quarterly refunding and on the composition of financing over the next two quarters reflects a significant concern on our part about the growing and uncertain forward financing calendar. We are also increasingly concerned about the recent concentration of funding in the shorter dated maturities and the weekly bill series in particular, even though we acknowledge the working capital nature of the RTC-generated demands. Given this concern, the Committee believes Treasury should bias its financing composition going forward toward a extending maturities. This bias should be an issue of degree and not a fundamental policy shift on working capital financing.

The Committee endorses significantly increasing the emphasis on the quarterly refunding, as well as all cycles other than the weeklies. In this vein, the Committee considered suggesting additional cycles which could diversify the recent focus on net bill funding. The Committee discussed instituting a 1-year to 18-month coupon cycle and/or the potential of a bimonthly year bill sale. These ideas, however, only underscore the Committee's sense that a primary emphasis on the regular bill market as the primary source for incremental financing should receive a fresh look.

Some of the arguments supporting this view were:

(1) Treasury should maintain some reserve of flexibility toward the bill market in an uncertain environment.

(2) Heavy bill financing has the potential at some point to impact all markets as relatively higher bill rates ripple out the yield curve across the credit spectrum.

(3) Individual investor demand, as reflected in more noncompetitive bid applications, seems to be favoring longer maturity securities.

(4) The nature of the RTC needs may have a longer duration and may be significantly larger than previously expected, thus changing the nature of the funding requirement.

(5) Stepped up capacity is comfortably available in the coupon cycles and in the quarterlies.

With these thoughts in mind, the Committee recommends by a vote of 15-4 that a $32.25 billion offering of new securities be sold at yield auctions to refund $20 billion maturing securities and raise $12.25 billion new cash. The recommended composition is:

- $11.5 billion 3-year notes due 8/15/93;
- $10.5 billion 10-year notes due 8/15/2000;
- $10.25 billion 30-year bonds due 8/15/2020.

For the remainder of the current quarter, the Committee recommends:

- Sell $11.75 billion 2-year notes raising $2.3 billion in new cash;
- Sell $9.00 billion 5-year notes raising all new cash;
- Sell $10.75 billion 52-week bills in August and $11 billion 52-week bills in September, raising $2.7 billion new cash;
- Maintain the weekly 3- and 6-month bill auction size at $18.4 billion, raising a total of $15.80 billion; and
- Sell $10 billion cash management bills in early August for April maturity, raising all new cash.

Summary of New Cash for the July-September Quarter

Refunding	$12.25 billion
3- and 6-month bills	15.80
52-week bills	2.70
Cash management bills	10.00
2-year notes	2.30
5-year notes	9.00
Estimated foreign add-ons	2.80
To be raised	$54.85
Already raised	24.75
Paydown September cash management	6.00
Net market borrowing	$73.60 billion

In addition, the Committee anticipates the need for a significant short term cash management bill of approximately $10 billion for payment by August 31 maturing on September 20 to bridge a low point in the Treasury's cash balance.

Reflecting the Committee's concern over the heavy supply in the October-December quarter, the Committee recommends an end-of-September cash balance of $40 billion. This high cash balance will allow for greater flexibility in meeting the subsequent quarter's need and reflects the view of using all cycle slots when available to fund the heavy forward schedule.

For the October-December quarter, the Committee suggests continued emphasis on all cycle auctions including modest additions to the weekly bills. For purposes of proposing a financing schedule for the fourth quarter, the Committee assumed $20 billion of RTC funding and no benefit from current budget negotiations. This left the group with an estimated $90 billion funding requirement in the quarter and we recommend a $25 billion end of quarter cash balance.

Summary of New Cash for the October-December

Additions to 2-, 4-, 5-, and 7-year coupon cycles	$25.25 billion
Refunding	10.50
1-year bills	6.66
Weekly bills	18.89
Long dated cash management bill in December	10.00
Foreign Add-ons	3.70
Net market borrowing	75.00
Reduction in cash balance	15.00
Total requirement	$90.00 billion

As an additional comment, the Committee recommends that the Treasury implement a procedure of rank-ordering coupon bids to a third decimal on a yield basis as the means of determining accepted bids in coupon auctions. The Committee vote was 12 to 7 favoring this initiative.

The Committee believes that one basis point bidding increments hurts participation in longer maturity auctions. One basis point movements are not reflective of underlying market practice, nor does it allow for effective risk management for those participating in auctions as a large W.I. underwriter and/or distributor. The fact is that one basis point on a 30-year bond is nearly 1/8 of a point in price. Many auction participants feel that the cost of a "step-up" bid of one basis point is too high to justify the auction set-up exposure. Moving to a third decimal yield bid would eliminate this concern and enhance auction participation, leading to lower Treasury costs.

Since most Committee members believe this procedure should be applied to all coupon auctions consistently, there was concern that investor and Treasury operational problems might develop in implementing this procedure broadly. The Committee would be pleased to work with the Treasury to refine this suggestion and consider alternatives which might facilitate this initiative.

Mr. Secretary, that concludes our report and we welcome questions and discussion.

Jon S. Corzine
Chairman