Report to the Secretary of the Treasury
from the Treasury Borrowing Advisory Committee
of the Securities Industry and Financial Markets Association

August 5, 2009

Dear Mr. Secretary:

Since the Committee convened in late April, the contraction in economic activity has persisted but at a slower pace, while financial conditions have continued to improve. Aggressive fiscal and monetary policy efforts have played a critical role in slowing the speed of economic contraction. Such efforts have closed off the threat of a failure of a systemically significant financial institution, which in turn is curbing financial market volatility and contributing to the unlocking of credit markets. The Federal Reserve's holding of the funds rate near zero, joined with its asset purchase and liquidity programs, has normalized risk spreads in various markets. At the same time, stepped-up government spending and tax cuts and credits are helping to stabilize aggregate demand.

These policy efforts along with aggressive restructuring efforts by businesses, especially on the cost and inventory front, have reduced the likelihood of continued outsized declines in the economy. Nonetheless, the path ahead will be a challenging one. The necessary deleveraging of the household sector is considerable and has further to run, while the financial sector remains focused on balance sheet repair. Until both sectors are healed, the economy's underlying trajectory will be muted.

Price pressures likely will remain contained. Headline prices are falling outright on a year-over-year basis and less volatile core inflation rates also are trending lower. Multi-decade highs in unemployment and spare capacity are forcing businesses to price goods and services competitively or risk steep declines in market share. Sluggish labor market conditions – employers continue to cut not only headcount but also hours and compensation of workers still on payrolls – are constraining consumers' purchasing power.

With the federal funds rate at its lower nominal bound, the Federal Reserve is continuing its credit and quantitative easing programs in an effort to further improve financial conditions. Unless Fed officials increase the Treasury purchase program announced in March, that component of quantitative easing will be completed sometime this quarter. However, the Fed's purchase of mortgage backed securities is far from completion and will continue to be a source of monetary stimulus ahead.

Treasury yields across the term structure have risen since the Committee met in April. Higher yields are a by-product of the slowing in the rate of economic contraction and uncertainty about the timing and method by which the Federal Reserve will begin to unwind its extraordinary policy measures. Despite the rise in rates in the inter-meeting period, yields remain low by historical standards.

The government's considerable funding needs are problematic for the longer-end of the Treasury market. This year's double-digit as a percent of GDP budget shortfall is unsustainable. Moreover, there is little support for a marked shrinking in the deficit in the year ahead, as revenue trends likely will remain sluggish amid high unemployment and lingering capital losses and public spending will remain elevated as a share of the economy. Various policy efforts under discussion by the Administration and Congress also probably would add to the deficit and public debt on a net basis.

While unlikely to materially affect real long-term interest rates today, a sustained period of rapid government debt accumulation could force real rates notably higher at some point in the future. A pick up on the margin in private-sector credit demand from a more stable real economy could be the first substantive test of how global financial markets are able to digest historically high government debt issuance.

Against this backdrop, the first charge to the committee focused on the adjustments, if any, needed to debt issuance. While the committee noted that the fiscal situation and commensurate net borrowing needs have continued to deteriorate, committee members agreed that previous additions to the coupon issuance calendar are sufficient to meet short and intermediate funding needs.

In fact, with the coupon calendar currently in place, the average maturity of issuance now exceeds the average maturity of marketable debt outstanding. This suggests that the decline in the average maturity of debt outstanding that that we have witnessed over the past seven years – from a high of approximately 70 months in 2000 to a low of approximately 50 months earlier this year should be arrested and begin to slowly lengthen going forward.

While the committee did not see the need to announce any new coupon issues, it was agreed that the Treasury should continue to increase the size of each existing coupon auction consistent with changes in net borrowing needs.

Several members pointed out that while auction sizes have grown materially, there was very good market acceptance of these securities and that the auctions have gone more smoothly than anticipated. This is particularly noteworthy given the recent improvement in the stock market and other risk assets when Treasury securities are generally less attractive than in flight to quality environments that were prevalent earlier in the year.

In the second charge, the committee was asked to address potential changes or adjustments to the TIPS program in order to improve the liquidity, and maximize the diversification benefits of inflation-linked debt issuance. One member prepared a presentation in advance of the meeting, which is attached to these minutes.

The member provided some background and history of the TIPS market in order to chronicle a program which took longer than expected to gain broad acceptance, and has suffered from periods of relative illiquidity, particularly when compared to the extensive investor penetration and liquidity of the larger nominal Treasury market.

This relative illiquidity, especially during periods of more intense overall market illiquidity, has caused a somewhat higher cost to the Treasury over time. Yet, the magnitude or the existence of this higher cost is difficult to determine due to a lack of consensus on how to measure that incremental cost.

In addition, the member pointed out that the ancillary benefits which the program has provided, including a market-based estimate of inflation has served to mitigate some of the potentially higher borrowing costs of the program. Yet, the member did cite that TIPS as an accurate barometer of inflation expectations can be skewed by market conditions, such as in the Fall/Winter of 2008 when market-wide de-levering may have influenced the pricing of this product. This speaks though, to a market which is clearly not as deep or as well accepted broadly as the fixed-coupon or "nominal" Treasury market.

The ensuing discussion on TIPS then shifted to an evolving set of developments in the TIPS market, related to a growing and potentially growing investor-base for the product, especially during periods of higher anticipated inflation.

There was mention by the presenting member, although not widely echoed by others on the committee, that there have been higher level of flows into the product from Central Banks and Sovereign Wealth funds, and specifically how those investors preferred being on the shorter end of the maturity spectrum (i.e. up to 5-year maturities). There has also been a movement of retail investors into the product as "inflation-hedges" to their portfolio. In addition, there are a number of private and public pension funds, which are considering implementing the product into their portfolios as natural inflation hedges to their liability streams. Ironically, many of those investors have been forced to sell TIPS recently as a means for managing their liquidity, as other products have been more difficult to sell such as private equities or hedge fund investments.

The member went on to discuss how real rates on TIPS strongly correlate with real GDP, and how governmental tax receipts tend to move alongside of inflation. The point being that both of these dynamics tend to serve as a natural hedge to the Treasury, as the costs of this program tend to rise alongside of periods of improving economic conditions (and concurrently higher levels of inflation).

The committee went on to discuss the member's findings and recommendations and determined that Treasury should move down a largely unchanged path from its current issuance patterns. And that a number of the limitations and costs associated with the program have been mitigated by some of the more recent developments, including new, and potentially new investors, coming into the product.

The committee felt as if there were some modest adjustments which could be made to the program, which would enhance liquidity and market receptivity, including more frequent auctions, even if they were smaller in size. Also recommended was a potential shift of the longer-dated issuance from 20 to 30 years, as the 20-year part of the curve is considered a less active and less desirable part of the yield curve for longer-dated investors such as pension funds and insurance companies.

Finally, the committee felt that while TIPS may still not be nearly as widely as accepted a program as fixed-coupons (i.e. the costs to Treasury can still be relatively higher), that the current need for issuance vehicles and growing nominal issuance should call for continued or even modestly larger notional issuance levels.

In the third charge to the committee, the Treasury asked for our thoughts on recent trends in market conditions and their impact on the Treasury market. One committee member prepared a presentation in advance of the meeting and those exhibits are appended to these minutes.

In his presentation to the committee, the member highlighted several important observations. These observations included:

- a significant deterioration in the federal budget balance as a percentage of GDP
- a recognition that in spite of this deterioration, the U.S. fiscal position is not materially worse than many other G-7 countries
- Tax receipts traditionally lag in economic recoveries and consequently, projections for FY10 deficits show little improvement irrespective of economic performance.
- Households have increased their leverage significantly over the past 25 years and this leverage has allowed the contribution of household spending to GDP to rise materially over this period. Consequently, a de-levering of the consumer may pose a long headwind to economic growth.
- The personal savings rate has reversed a 30 year decline and may be poised to rise significantly.
- Long-term inflation expectations are still contained.
- While the Federal Reserve's intervention in the U.S. mortgage market has been helpful, conditions outside of the agency backed market are still highly problematic.
- Interest-rate volatility in the longer part of the government market has remained elevated even as other risk assets have performed very well.

And with respect to these factors and others, and their effect on the Treasury market, this member observed that daily trading volumes had declined in spite of increased supply in the market. Members attributed this primarily to the reduced balance sheets of dealers and hedge funds engaged in the trading of Treasury securities.

It was also noted and shown that while "tails" and "reverse-tails" (yields coming through expectations at auctions) have increased from recent years, these outcomes do not look that unusual compared to the early 2000's when the Fed held a similarly low level of Fed Funds and the outlook for the economy was equally uncertain.

And finally, the member presented a historical look at other key auction statistics and the general conclusion is that while these auctions are clearly larger in size, there is no clear deterioration in participation in auctions or overall acceptance of Treasury Securities.

In the final section of the charge, the committee considered the composition of marketable financing for the July to October Quarter to refund the $60.9 billion of privately held notes and bonds maturing August 17, 2009. The Committee recommended a $37bn 3-year note due August 15, 2012, a $24 billion 10-year note due August 15, 2019 and a $15 billion 30-year bond due in August 15, 2039.

For the remainder of the quarter, the Committee recommends two 2-year notes of $44 billion in August and September, a 3-year note of $37bn note in September, 5-year notes of $40 billion in August and $41bn in September, 7-year notes of $29bn in August and $30bn in September, a $20 billion re-opening of the 10-year note in September, and a $12 billion re-opening of the 30-year bond in September.

For the October to December quarter, the Committee recommended financing as found in the attached table. Relevant figures include three 2-year, 3-year, 5-year and 7 year note issuances monthly, 10-year note and 30-year bonds in November with two 10 and 30-year re-openings, as well as a 10-year Tips note in October, and a 20-year TIPS re-opening later that same month.

Respectfully Submitted,

Keith Anderson, Chairman

Rick Rieder, Vice Chairman