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

August 3, 2010

Dear Mr. Secretary:

When the Committee met in early May, the economy was firmly transitioning to a self-sustaining expansion. Economic releases since then suggest that this progress has slowed. Business spending and private employment rose at a solid pace last quarter but momentum appears to have slowed into midyear. Similarly, the robust gains in retail spending recorded early this year has been tempered by recent weakness. Rising uncertainty about growth prospects and the direction of policy has also weighed on consumer confidence. In all, the expansion continues to move forward but at a more modest pace than had been anticipated three months ago. This loss of momentum heightens lingering concerns about the expansion's resiliency in the face of a significant fiscal tightening planned for the quarters ahead.

The US economy has just completed a year of economic expansion in which real GDP rose 3.2%. Importantly, all components of private demand – consumption, fixed investment and inventory accumulation – contributed to growth in the first two quarters of the year. However, their relative magnitudes remain imbalanced. The latest figures show strong gains in business spending and inventory accumulation this year. In addition, exports are rising at a double-digit pace. Consumer spending, by contrast, is sluggish. Despite solid income growth, consumption rose at a 1.8% annualized rate in the first half as the household saving rate moved up to 6.2%. This mix of strong business spending and sluggish personal outlays has concentrated much of the gain in output to goods producing industries. Services GDP has increased at a meager 0.5% pace during the first year of economic expansion.

The US manufacturing sector has benefited from the lift in domestic and foreign goods demand with output rising 8.3% over the past year. This year of boom has realigned depressed levels of manufacturing activity to final demand. With inventories now rising, output growth is poised to slow. The slide in the ISM manufacturing survey to 55.5 in July suggests moderation is underway. A downshift in manufacturing following a bounce is a regular feature of the early stages of US expansions. Generally, service sector activity tends to improve as the expansion matures and the manufacturing lift fades. With the downshift in production indicators providing less of a directional signal, demand and labor market indicators will shoulder the burden of highlighting the progress of this rotation and the underlying health of the expansion.

The continued shift by cash-rich firms away from a defensive posture is likely to provide further fuel for growth in the coming quarters. Adjusted corporate profits are estimated to have increased more than 35% over the past year, the most rapid rise in more than a quarter century. Although the lift to growth from a shift away from paring inventories management is largely spent, a recovery in capital spending and hours worked from depressed levels remains in its early stages. The tentative expansion now underway should receive additional support in the coming quarters as credit availability improves and global demand continues to rise. It is encouraging that last quarter produced the expansion's first material rise in private payrolls (1.6%, saar) although momentum on hiring appears to have slowed as the quarter came to an end.

Households are expected to remain cautious in the coming quarters as they continue to adjust their balance sheets to an environment of weak labor and housing markets. With saving rates drifting higher, rising labor income will be the key for bolstering confidence and sustaining modest consumption gains. The first half of this year provided encouraging news as labor compensation rose at a 2.7% pace. More disappointing has been the sharp drop in home sales with the end of tax incentives. Household credit quality appears to be improving but an overhang of existing homes in the foreclosure process looks likely to limit any lift in home prices.

In spite of a year of growth, resource utilization remains depressed and disinflationary pressures persist. Over the past year, the core CPI rose at less than 1%, the slowest pace since the early 1960s. With trends in hourly labor costs still moving lower, inflation will likely stay low for some time to come. Faced with high unemployment and very low inflation, the recent loss of growth momentum has raised concerns that the economy could slip into deflation. The Federal Reserve has responded by balancing its discussion of exit strategies with rhetoric that signals it would consider additional monetary stimulus if needed. The Federal Reserve looks likely to remain on hold for some time to come and asset sales will wait until levels of employment and inflation are consistent with a tightening in policy.

US monetary policy will need to maintain an extremely accommodative stance in part because fiscal policy is turning restrictive. The ARRA federal stimulus is already fading and state and local spending is likely to continue to contract at its current 1.5% pace. As the economy turns towards next year, ARRA federal transfers to states will end and a number of tax cuts will expire. Although accommodative monetary policy is expected to provide an important offset to this drag, policy rates are already close to zero. The Fed has limited tools to employ should growth disappoint or inflation expectations fall precipitously.

Against this economic backdrop, the Committee's first charge was to examine what adjustments to debt issuance, if any, Treasury should make in consideration of its financing needs. In the near term, the Committee felt a continued reduction in nominal coupon issuance was appropriate. However, coupon issuance sizes will likely stabilize at or about the end of calendar year 2010. Given the uncertain economic and fiscal backdrop, the Committee felt that maintaining maximum flexibility was necessary.

The bulk of the reduction in coupon issuance should continue to be in the two-year, three-year, five-year and seven-year maturities. Although this is broadly consistent with the Committee's desire to increase the average maturity of the outstanding debt, some felt that given the meaningful progress thus far, reductions in ten-year notes and thirty-year bonds could be justified.

The Committee discussed both the relative and absolute size of the Treasury bill market. One member commented that bills should not drop below twenty percent of marketable Treasury debt outstanding. However, the Committee concluded that more work needed to be done to better understand the evolution of Treasury bill demand dynamics. Finally, the Committee felt that growing TIPS from roughly $80 billion gross issuance in fiscal year 2010, to over $100 billion in fiscal year 2011, was still appropriate.

The second charge was an examination of the current state of the municipal bond market. The member looked at municipal market dynamics, the ability of issuers to access the markets, risk factors, and the impact of municipals on fixed income markets more broadly.

The presentation (see attached) highlights that municipal bonds outstanding rose over the last decade by $1 trillion to $2.8 trillion. Despite some of the recent headline risks and the challenging economic outlook, the member concluded the municipal market appears to be in reasonably good condition. Broadly, municipalities still have a low probability of default, historically high recoveries, low absolute cost of funds, access to a broader investor base via the Build America Bonds program, and a largely unlevered existing retail investor base. Implicit in this analysis is the Federal government's willingness to intervene in the event the municipal market ceases to function.

The third charge was to examine the demand for long duration fixed income assets amidst the backdrop of a gradual increase in the average maturity of debt outstanding. The member focused on the impact of the Federal Reserve's asset purchase program. In particular, the presentation (see attached) highlights the absence of mortgage hedging needs as a stabilizing force underpinning long term yields. In addition, the member referenced the secular increase in demand for long duration assets from asset managers, insurance companies, and pension funds. Furthermore, cyclically, the member showed that investor confidence in the path of central bank policy rates tends to anchor long term yields.

In the final charge, the Committee considered the composition of marketable financing for the remainder of the July-September quarter and the October-December quarter. The Committee's recommendations are attached.

Respectfully,

Matthew E. Zames
Chairman

Ashok Varadhan
Vice Chairman