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

May 2, 2000

Dear Mr. Secretary:

Since the Committee's last meeting on February 1, the US economy has remained strong, with the Commerce Department recently reporting that GDP posted a 5.4% annualized growth rate in the first quarter. This is particularly impressive since it follows on the heels of a 7.3% gain in GDP in the final quarter of 1999. The consumer continues to provide much of the fuel for the expansion, as personal consumption spending registered an impressive 8.3% advance in Q1. The strength in consumer demand appears to reflect both a solid underlying pace of income growth and the lagged effect of the wealth creation that has occurred during recent years. At this point, there are few signs of any significant underlying moderation in economic activity, although the economy is expected to post a somewhat more modest pace of growth in the current quarter.

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. Still, core inflation seems to have ticked up of late. Indeed, the financial markets were unnerved in mid-April by a reported +0.4% rise in the CPI excluding food and energy items for March. Moreover, there are increased signs that the tightness in labor markets may be finally leading to acceleration in wage and benefit costs. The Labor Department recently reported the employment cost index jumped +1.4% in Q1, the sharpest gain in more than ten years. To be sure, productivity appears to be expanding at a rapid rate, which is helping to keep a lid on overall unit labor costs.

Despite the fact that the FOMC announced 25 basis point rate hikes on February 2 and again on March 21, Treasury yields generally trended lower during much of the three-month interval since our last meeting. This move appeared to largely reflect an ongoing adjustment to shrinking Treasury supply, as well as some portfolio reallocations tied to extreme volatility in the equity and private credit markets. Spreads between Treasuries and most other fixed income securities have widened over the period since our last meeting. For example, 10-year swap spreads moved from about 75 bp in the period leading up to the February refunding announcement to a peak of nearly 140 bp on April 10. During the past couple weeks, Treasury yields have reversed course and begun to move higher prompted by inflation

concerns and the accompanying possibility of a more aggressive pace of Fed tightening, while private credit market spreads have narrowed somewhat.

Against this backdrop, the Committee considered the composition of a financing to refund approximately $30.6 billion of outstanding debt, consisting of $27.8 billion of privately held notes and $2.7 billion of bonds to be called on May 15, to pay down approximately $8.6 billion of cash.

The Committee unanimously recommends a total financing of $22 billion consisting of the following offerings:

- $14.0 billion 5-year notes due May 15, 2005, and
- $8.0 billion of the 6.5% notes due February 15, 2010.

In regard to the composition of Treasury marketable financing for the remainder of he current quarter, the Committee recommends that the Treasury meet its borrowing requirement in the following manner:

- Two 2-year notes of $12.0 billion each,
- A 1-year bill of $10.0 billion, and
- A cash management bill of $15.0 billion to mature within the quarter.

For the July-September quarter, the Treasury estimates a net market paydown of $47 billion with a cash balance of $45 billion on September 30. To accomplish this requirement, the Committee preliminarily recommends the financing schedule in the attached table.

Within the context of evidence of continued improvement in the U.S. fiscal outlook, the Committee considered what further adjustments to issuance size and frequency it would recommend at this time. While acknowledging uncertainty regarding the necessity for immediate change, the Committee reiterated its view that the elimination of the one-year bill should be the next step for the Treasury if additional reductions in issuance are required. The Committee favored a reduction in the frequency of two-year notes as the next alternative which would be the least disruptive to the goal of preserving liquidity, to the greatest extent possible, in benchmark Treasury issues. Importantly, the Committee feels that if a reduction in the frequency of two-year notes becomes necessary, an immediate change to quarterly offerings would be the most appropriate decision to attain the goals of providing financing flexibility for the Treasury and preserving maximum liquidity in benchmark issues.

At the Treasury's request, the Committee considered its views on the buyback program, specifically experiences to date, and possible modifications going forward, with particular focus on the size, regularity, maturity range, and notice period for buyback operations.

Based on experience to date, Committee members believe that the program has been very effective with large and broad-based domestic participation. Participation by offshore entities appears to have been small in early operations.

With respect to future operations, the sense of the Committee was that the Treasury would be best served by pre-announcing a regular schedule for buybacks at least one quarter in advance. The Committee believes that such a schedule would reduce market disruptions and ultimately allow the Treasury to pay lower prices for the securities repurchased. Most members favored weekly or biweekly operations, with a majority favoring weekly operations of $500 million to $1 billion and a minority favoring biweekly operations of $1 billion to $2 billion in the current year. A few members expressed a preference for one large operation per quarter. It was unanimously agreed that a one-day notice period between the announcement of the specific size and maturity range of an operation and the actual operation would be sufficient for participants. On maturity ranges, the Committee believes that a 3-year to 5-year maturity band is preferable if the Treasury were to choose to do smaller, weekly operations and a maturity band with more issues, probably closer to the 5-year band, would be preferable under the biweekly alternative. Finally, members noted that at some point, the Treasury should consider extending the program beyond the 15 to 25-year maturities, to include 10-year issues and debt callable in the 10-year sector as well as some issues in the 25 to 30-year maturity range.

Some Committee members suggested that the Treasury consider, as a supplement to the buyback program, an exchange operation. This would allow investors to exchange older, seasoned issues for newly issued current coupons. Committee members felt the Treasury ought to begin exploring the feasibility and mechanics of such an operation. If budget surpluses continue to build and Treasury buybacks continue, an exchange operation or ultimately a facility, could serve to enhance liquidity of seasoned issues and benchmark securities.

Respectfully submitted,

Kenneth M. deRegt