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

February 1, 2000

Dear Mr. Secretary:

Since the Committee's last meeting on November 2, 1999, the US economy has continued to expand at a rapid pace, with the Commerce Department recently reporting that GDP posted a 5.8% annualized growth rate in the fourth quarter. Solid gains in consumer demand are responsible for the bulk of the strength in GDP during the second half of 1999, but the breadth of the global recovery points to a likely near term rebound in exports as well. There are few signs at this time that the higher interest rate structure is cooling the pace of economic activity. On the inflation front, higher oil prices have pushed up headline readings for CPI and PPI in recent months. Moreover, there are some signs that the tightness in labor markets may be leading to an acceleration in wage and benefit costs. However, productivity appears to be expanding at a rapid rate, which is helping to keep a lid on overall unit labor costs. Indeed, there is still little indication of a pick-up in underlying price pressures at this point. On balance, the outlook for the U.S. economy continues to appear quite favorable.

With the FOMC announcing a 25 basis point rate hike on November 16, Treasury yields generally continued to trend higher since our last meeting. Factors responsible for the trend included: continued evidence of a robust domestic economy, signs of an improving global economic environment, continued strength in equity markets, and the absence of any significant Y2K-related disruptions. On January 13, the Treasury unveiled the details of its program to repurchase up to $30 billion of securities this year. Most importantly to market participants, the Treasury announced that government accounting rules would not treat any premium purchase as a budget outlay.

This announcement contributed to a narrowing of spreads between benchmark issues and off-the-run securities, and seemed to be a catalyst for lower bond yields, and an inversion of the yield curve between the 10- and 30-year sectors. Other technical and fundamental factors—such as mortgage hedging activity, the supply of intermediate sector securities, rising budget surplus forecasts, and more aggressive expectations and pricing of the scope and pace of Federal Reserve rate increases appear to have reinforced the movement of 30-year yields relative to the rest of the Treasury yield curve.

Within this context, and against a backdrop of expected large fiscal surpluses, the Committee considered a number of issues related to the Treasury's financing plans.

In response to a question regarding the average maturity of the debt in the current fiscal environment, the Committee noted that a significant extension would occur assuming current budget surplus projections, unless substantive changes are made in the financing schedule. Members expressed the view that the average maturity of the debt should be stabilized, and ideally brought down as debt is retired. With the additional goal of maintaining sufficient market liquidity to promote orderly markets, members considered a number of alternatives in response to the Treasury's request to make recommendations concerning additional adjustments to its financing plans this year.

Specifically, the Committee recommended a reduction in the issuance of 52-week bills to 4 issues per year, with a goal of the eventual elimination of the instrument. Members continue to feel that the 52-week bill offers the least incremental utility to investors relative to alternative investments with similar maturities. Any ability to issue additional securities should be directed to enhancing the liquidity of the 3- and 6-month bill sectors.

The Committee strongly supported the establishment of a regular reopening policy for the quarterly refunding issues in order to allow for some further reduction in issue size while preserving market liquidity to the greatest extent possible. The Committee's recommendation was consistent with the principle of offering new 5- and 10-year notes in quarters where long bonds were not being offered.

In the discussion of the extending average maturity profile and the reduced liquidity of benchmark Treasury issues, the Committee noted that inflation-indexed securities have been growing rapidly as a share of total Treasury issuance, and without a change will contribute significantly to a lengthening of the average maturity of the debt. In addition, some members expressed the view that this debt represented an excessive cost to the Treasury. The Committee supported eliminating the 30-year inflation-indexed issue that would normally be auctioned in April with the objectives of stabilizing the proportion of TIPS issuance, and reducing the contribution of TIPS to the extension of the average maturity.

Specifically, the Committee recommended a financing to refund approximately $27.6 billion of privately held notes maturing on February 15 and to issue $32 billion in notes and bonds consisting of the following offerings:

- $14.0 billion of the 5-7/8% notes due November 15, 2004
- $8.0 billion of the 6% notes due August 15, 2009
- $10.0 billion of a 30-1/4 year bond due May 15, 2030

The reopenings of the 5- and 10-year notes were supported to allow the Treasury to establish a regular reopening pattern consistent with the principles outlined earlier, in addition to enhancing market liquidity.

The recommendation for a new 30-1/4 year bond was made in the context of the Treasury's limited ability to offer new bond issues, the desire to enhance the relatively limited supply of May and November coupons in the Treasury STRIPS market, and a view to a reopening of this issue in smaller size at a later date to support the dual goal of stabilizing the average maturity of the debt and enhancing market liquidity.

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

- Two 2-year notes of $14.0 billion each,
- A 1-year bill of $10.0 billion,
- Weekly issuance of 3- and 6-month bills through the remainder of the quarter, and
- Three cash management bills totaling $102 billion to mature in late April.

For the second calendar quarter, the Treasury estimates a net market paydown of about $152 billion with a cash balance of $40 billion on June 30. To accomplish this requirement, the Committee preliminarily recommends the financing schedule in the attached table.

Finally, the Committee considered a series of questions related to the Treasury's buyback program. The Committee felt that the Treasury should not be constrained by a particular maturity range in its operation, but should purchase securities with the highest yields consistent with the average maturity goal. Members continue to feel that the Treasury can operate consistent with the Federal Reserve coupon pass format with a relatively short notice period, while acknowledging the desirability of allowing some additional time in early operations. Although the Treasury might want to start with a relatively small operation, the Committee felt that fewer and more sizable buybacks consistent with market conditions, would prove most effective and least disruptive.

In an environment of declining Treasury debt issuance, the Committee discussed, at the Treasury's request, the implications for financial markets and possible risk to the government of the following: the increasing globalization of the markets, hedging and pricing practices in fixed income markets, and the growth of Government Sponsored Enterprises.

The impact of the globalization of fixed income markets has been a significant broadening of the investor base for Treasury debt, and an increasing focus on non-sovereign alternatives. Concerning hedging and pricing practices in fixed income markets, members noted the greatly increased use of agency debt and swaps for hedging purposes in a broad spectrum of fixed income transactions by all market participants—with a particularly notable increase by end-users. This has occurred in a favorable credit environment with a rapid increase in the issuance of agency debt and other credit market instruments compared to Treasury new issues. The development of market liquidity in these alternative hedging instruments has been successful to date, but is unproven in a more difficult credit environment. As to the possible risks to the government of the growth of Government Sponsored Enterprises and alternative hedging markets, there was no consensus on the Committee as to how to assess the nature and severity of this risk.

Respectfully submitted,

Kenneth M. deRegt