Research
Government Forecast

SIFMA
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The Securities Industry and Financial Markets Association[1] is pleased to report the results of its Quarterly Government Securities Issuance and Rates Forecast. The forecast reflects the responses to a survey[2] of members of the Association's Government Securities Research, Analysis and Strategy Committee.The Committee is composed of trading strategists and research analysts at Association member firms who specialize in the U.S. government and agency securities markets. The survey is intended to provide market participants with the current consensus expectations and median forecasts of many of the Primary Dealers and other firms active in the U.S. government and agency securities markets.[3]

Fourth Quarter Total Net Issuance Projected to Rise on Increases in Government Spending

The median survey response forecast total net Treasury bill, note and bond issuance to be $444.5 billion in the fourth quarter of 2009, compared with the net $392.5 billion issued in the third quarter and $569.3 billion issued in the fourth quarter a year ago.[4] The jump in projected net issuance between the third and fourth quarters of 2009 reflects expectations for increased borrowing needs due to continued economic weakness and increases in government spending in connection with stimulus efforts.

Net Coupon Issuance Expected to Rise; TIPS Issuance Expected to Stay Flat; Cash Balances Significantly Lower

The median forecast for net new issuance of Treasury coupon securities is $451.5 billion for the fourth quarter, 11 percent above third quarter net issuance recorded of $406.5 billion, and significantly above the net $192.4 billion issued in the fourth quarter of 2008.[5] In addition, the committee believes the Treasury Department will finish the quarter with a cash position of $85.0 billion, 71.2 percent below the balance of $295 billion at the end of the third quarter, and 76.8 percent lower than the $367 billion cash balance a year ago.[6]

The median fourth quarter forecast for gross nominal coupon issuance is $572.5 billion, relatively flat when compared with the $561.0 billion issued in the third quarter but significantly above fourth quarter 2008 gross issuance of $361.0 billion. According to the survey, the Committee forecasts Treasury will issue $14.0 billion of Treasury Inflation-Protected Securities (TIPS) in the fourth quarter, same as the $14.0 billion issued in the third quarter.

The median forecast for gross combined coupon and TIPS issuance in the fourth quarter is $586.5 billion, relatively flat when compared to the $575.1 billion recorded in the third quarter and again, significantly above the $353.4 billion in the fourth quarter of 2008. Of the $586.5 billion total gross issuance projected for 4Q 2009, approximately 23 percent will be 2-year notes, 20 percent in 3-year notes, 21 percent in 5-year, 15 percent in 7-year, 11 percent in 10-year notes, 7 percent will be 30-year bonds and 2 percent will be TIPS.

1 The Securities Industry and Financial Markets Association brings together the shared interests of more than 600 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

2 The survey was conducted the week beginning October 9, 2009. The Committee received responses from ten firms represented on the committee.

3 Previous survey reports may be found at www.sifma.org/research/govt-rates.shtml.

4 The dates and numbering of quarters are based on calendar year rather than fiscal year unless otherwise noted.

5 Net coupon projections for the fourth quarter of 2009 ranged from net issuance of $285 billion to net issuance of $465 billion.

6 Net cash position projections for the end of the fourth quarter 2009 ranged from $50 billion to $270 billion.

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Net Bill Issuance Projects Paydown

The survey projected net bill redemption of $7 billion for the upcoming fourth quarter, compared to net redemption of $14 billion in the third quarter and a net issuance of $376.8 billion in the fourth quarter of last year. The wide range of responses, however, highlights the uncertainty in this area.[7] Gross bill issuance is expected to total $1.2 trillion for the fourth quarter by the Committee respondents, lower than the $1.63 trillion in the third quarter and the $1.96 trillion recorded in the fourth quarter of 2008.

U.S. Treasury Yield Outlook – Treasury Yield Curve Expected to Continue Steepening

The Committee's median forecast projects the benchmark Treasury yield movement to be mixed in the fourth quarter compared to those prevalent at the time the survey was taken.[8] Generally, yield rates are expected to increase through the remainder of 2009 and into the first quarter of 2010, suggesting a lesser demand for government-guaranteed and -sponsored debt as the general economy seems to have started the path to normalization.

The median forecast for the 10-year Treasury yield were 3.53 percent for the fourth quarter of 2009 and 3.70 percent for the first quarter of 2010. Fourth quarter 10-year yield projections were wide ranging, from 2.50 percent to 3.85 percent. The median forecasts for the 30-year bond yield were 4.38 percent for the fourth quarter and 4.48 percent for the first quarter of 2010. Again, there was a fairly wide range of fourth quarter 30-year projections, from 3.30 percent to 4.70 percent. The 2-year Treasury note was forecast to yield 1.00 percent in the fourth quarter and 1.13 percent in the first quarter of 2010. The range around the fourth quarter 2-year yield projection was 0.70 percent to 1.30 percent.

The survey projects a slight steepening of the yield curve over the next few quarters as measured by the 2-year to 10-year Treasury yield spread. Over the past few months, there has been a steepening trend, with the 2-year to 10-year Treasury yield spread increasing to 236 basis points in early October from a low of 190 basis points at the end of the first quarter; the average spread year-to-date has been 225 basis points. Based on the median projections, the 2-year to 10-year Treasury yield spread will be 253 basis points for the fourth quarter and 257 basis points for the first quarter of 2010.

Economic Rebound and Inflation Main Rate Upside Risks; Weak Overall Economy and a Return to Risk Aversion are Main Downside Risks

The survey asked participants about risks to their forecasts or events that could cause interest rates to move higher or lower than forecasted (summarized in Table 1). The dominant risks identified on the upside are an outperforming economy and inflationary concerns, whereas the dominant risks identified on the downside are deflationary concerns along with weaker than expected economic conditions and recovery.

Table 1. Summary of Surveyed Respondents on Risks to Rates

	Risks to Upside	Risks to Downside
#1	Economy outperforms expectations; End of Fed purchase programs; Overseas appetite for U.S. Treasuries reduced; Failure of Congress to raise the debt ceiling in a timely fashion	Economy underperforms; Credit-related developments for large financial institutions; Weak stock market
#2	Fed becomes spooked by inflation and decides to start a rate hiking cycle earlier than may be necessary (we expect the cycle will begin in late 2010).	The recovery gains no traction; the consumer deleveraging process is more elongated than we envision.
#3	We expect rates to grind lower with a modest curve flattening bias. We believe 10s and the back-end of the curve should outperform as near-term inflation concerns continue to decline.	While the abundance of liquidity should keep short rates very low, the front-end of the curve is at risk to policy actions. Short rates might underperform on the curve if the Fed implements any liquidity draining policy that the market might interpret to be a tightening signal.
#4	Higher commodity prices; Uptick in dollar FX rate; Second fiscal stimulus	Double dip recession; Expansion of Fed MBS purchases
#5	If the economic recovery is stronger than expected, prompting the Fed to raise rates sooner than expected, rates could be higher than our forecast. In addition, if the fiscal situation deteriorates dramatically, that could push up rates.	If the economic recovery slows, or if deflation fears increase, then rates could be lower than our forecast.
#6	Economy rebounds faster than anticipated and inflation expectations rise as market worries that Fed will not be able to withdraw liquidity fast enough.	Economy remains weak and stock market correction causes flight to quality into Treasuries.
#7	Slowdown of Fed purchases of Agency MBS; Slowdown in Treasury purchases from overseas investors, which has not happened yet; A faster upward adjustment to coupon sizes as Treasury tries to term out debt faster; Sticky core inflation: we expect core inflation to gradually decline but recent readings have been strong; Continued rally in risky assets	Implict in the forecast is back to normal GDP growth in Q3 and Q4, which if not realized, is likely to result in lower rates; Resurgence of risk aversion: LOIS basis, credit spreads, VIX have all been steadily declining - a financial market failure could result in a quick reversion
#8	Higher Yields: Economic recovery takes hold faster than anticipated; this leads to more aggressive Fed policy; 2-year yields move higher reacting to this; Increased inflation concerns	NA
#9	Economic upside surprise forces earlier pricing of Fed hikes	Re-emergence of risk aversion/financial blowup
#10	NA	NA

[7] *Net bill issuance projections for the fourth quarter ranged from redemption of $335 billion to an issuance of $210 billion. A net redemption, or negative net issuance number may be interpreted as a net paydown of outstanding Treasury debt.*

[8] *At the end of the survey period, October 21, the 2-year note yield was 0.95 percent, 10-year yield was 3.31 percent and 30 year yield 4.03 percent.*

Federal Agency Issuance; Federal Home Loan Banks Continue to Provide Liquidity

The survey forecasted total gross note issuance of $192.5 billion in the fourth quarter by the four largest Federal agencies, compared to $141.5 billion in the third quarter.[9] Nearly 42 percent of the issuance volume is expected to come from the Federal Home Loan Banks (FHLBs), reflecting their continued importance as a source of bank liquidity during sluggish credit market conditions. Fannie Mae and Freddie Mac are projected to account for over 23% and nearly 26% of issuance, respectively.

Agency-to-Treasury Spreads; LIBOR Expected to Increase Slightly

The respondents expect agency yield spreads to Treasuries to mostly decrease from third quarter levels in the fourth quarter (except for the 2-year agency benchmark/reference notes).

At the end of the third quarter in 2009, 3-month LIBOR stood at a little under 0.29 percent and is expected to increase slightly throughout the remainder of this year and going into the first quarter of 2010. The median projections for 3-month LIBOR were 0.29 and 0.30 percent for the fourth quarter of 2009 and first quarter of 2010, respectively.

Mixed Recommendations on Weightings

The survey asked for model portfolio allocation recommendations, compared to the current portfolio weighting, across the maturity spectrum of the U.S. Treasury yield curve. The results are mixed and summarized in Table 2.

Table 2. Distribution of Weightings

	Strong Over	Over	Neutral	Under	Strong Under
0-3 yrs.	0%	20%	50%	30%	0%
3-7 yrs.	0%	30%	30%	40%	0%
7-10 yrs.	20%	0%	40%	30%	10%
10-30 yrs.	10%	20%	20%	40%	10%

[9] *Includes Fannie Mae, Freddie Mac, the Federal Home Loan Banks and the Federal Farm Credit Banks Funding Corporation.*

SIFMA's Government Securities Research Committee Forecast

Forecast numbers appear in bold

Issuance Projections	$ Billions	
	2009:Q3	**2009:Q4**
U.S. Treasury Borrowing[1]		
Net Coupon Issuance	407	**452**
Net Bill Issuance	(14)	**(7)**
Quarter end cash balance	295	**85**
U.S. Treasury Quarterly Gross New Issuance		
4 week Bill	432	**320**
13 week Bill	403	**396**
26 week Bill	391	**400**
52 week Bill	108	**81**
2 year Treasury Note	130	**133**
3 year Treasury Note	116	**119**
5 year Treasury Note	121	**125**
7 year Treasury Note	87	**90**
10 year Treasury Note	66	**65**
30 year Treasury Bond	41	**41**
Treasury Inflation-Protected Securities	14	**14**
Federal Agency: Projected Total Gross Coupon Debt Issuance[2]		
Fannie Mae	35	**45**
Freddie Mac	33	**50**
Federal Home Loan Bank System - Office of Finance	60	**81**
Federal Farm Credit Banks Funding Corporation	14	**17**
Federal Budget Deficit Estimate - FY	455 (FY08)	**1,419 (FY09)**

Rates & Spreads Outlook	Sept. 2009	% Yields Dec. 2009	Mar. 2010
Interest Rates (End of Quarter in % Yield)			
2 Year Treasury Note	0.95	**1.00**	**1.13**
5 Year Treasury Note	2.31	**2.50**	**2.61**
10 Year Treasury Note	3.31	**3.53**	**3.70**
30 Year Treasury Bond	4.03	**4.38**	**4.48**
3 Month LIBOR	0.28	**0.29**	**0.30**
2 Year Agency Benchmark/Reference Notes[3]	13	**20**	**20**
5 Year Agency Benchmark/Reference Notes[3]	40	**25**	**28**
10 Year Agency Benchmark/Reference Notes[3]	40	**37**	**40**
2 Year SWAP Spreads	35	**35**	**35**
5 Year SWAP Spreads	33	**35**	**35**
10 Year SWAP Spreads	13	**20**	**25**

1 *Excluding Federal Reserve's purchases*
2 *Including all callable coupon issuance and excluding all discount notes*
3 *Indicate Agency spreads to Treasury yield in basis points*