

SIFMA Quarterly Government Securities Issuance and Rates Forecast – First Quarter 2010

Greater Issuance from Spending Initiatives and More TIPS

First Quarter Total Net Issuance Projected to Increase on More Government Spending to Boost Employment and the Housing Market

The SIFMA Quarterly Issuance Survey¹ forecast total net Treasury bill, note and bond issuance to be \$417.0 billion in the first quarter of 2010, compared with the net \$159.5 billion issued in the fourth quarter of 2009 and \$481.3 billion issued in the first quarter of 2009 (these actuals include cash management balances).²

The \$159.5 billion net issued in 4Q'09 was below Treasury's November marketable borrowing estimate of \$276 billion, which can be partly explained by the lowering of the Supplementary Financing Program to \$15 billion from \$200 billion (announced in September). The jump to \$417.0 billion forecasted for 1Q'10 may partly reflect a return to net issuance levels consistent with the past year. The forecast increase in net issuance of \$24.5 billion between 3Q'09 and 1Q'10 may offer a better forward-looking comparison than the forecast increase of \$257.5 billion between 4Q'09 and 1Q'10.

The projected increase in net issuance also reflects continued demand for funds to cover government spending for additional stimulus efforts. Although the recession may be over, the economic situation remains weak, and as recently as last month the government announced plans for further job creation efforts, extension of unemployment benefits, and support for the housing market (i.e., extension of the homebuyer's tax credit).

Net Coupon and TIPS Issuance to Rise as Treasury Plans to Increase TIPS Auction Frequency; Cash Balances Continue to Fall

The median forecast for net new issuance of Treasury coupon securities (notes and bonds) is \$460.0 billion for the first quarter, 26.9 percent above 4Q'09 net issuance of \$362.5 billion, and

significantly (46.3 percent) above the net \$314.4 billion net issued in the first quarter of 2009.³ In addition, the survey respondents believe that Treasury will finish the quarter with a cash position of \$50.0 billion, 39.0 percent below the balance of \$82 billion at the end of the fourth quarter in 2009, and a huge drop of 83 percent since the end-3Q'09 cash balance of \$295 billion.⁴

The respondents also estimated the fiscal years 2010 and 2011 federal deficits will be approximately \$1.29 trillion and \$1.1 trillion, respectively, compared to the \$1.35 trillion and \$980.1 billion estimated for the same years by the Congressional Budget Office.

The Survey's issuance forecasts are reasonably in-line with Treasury's November marketable borrowing estimates for 1Q'10, which projected \$478 billion in net issuance of all marketable debt and an end-of-March 2010 cash balance estimate of \$45 billion (Treasury estimate includes \$15 billion for the Supplementary Financing Program).

The first quarter 2010 forecast for gross nominal coupon issuance was \$587.0 billion, slightly below the \$599.0 billion issued in the fourth quarter of 2009 but 27.9 percent greater than the \$459.0 billion gross issued in the first quarter of 2009. Survey respondents forecast Treasury will issue \$20.0 billion of Treasury Inflation-Protected Securities (TIPS) in 1Q'10, well above the \$14.1 billion issued in 4Q'09.

Treasury's November Quarterly Refunding Statement announced some changes to Treasury's TIPS auctions, including the elimination of all 20-year TIPS issuances and resumption of 30-year TIPS beginning on February 22. Treasury may also begin offering more frequent auctions in order to increase TIPS issuance and improve TIPS liquidity.

The median forecast for gross combined coupon and TIPS issuance in the first quarter is \$607.0 billion, a slight decrease from the \$613.1 billion recorded in the 4Q'09, but 27.6 percent greater than the \$475.7

¹ The survey was conducted the week beginning January 7, 2010. A description of the participants is provided on page 5. Previous survey reports may be found at www.sifma.org/research/govt-rates.shtml.

² Survey results are medians and the dates and numbering of quarters are based on calendar year rather than fiscal year unless otherwise noted.

³ Net coupon issuance projections for the first quarter of 2010 ranged from \$434 billion to \$510 billion.

⁴ Net cash position projections for the end of the first quarter 2010 ranged from \$20 billion to \$125 billion.

billion in 1Q'09. Of this total, approximately 22 percent is projected to be in 2-year notes, 20 percent in 3-year notes, 21 percent in 5-year notes, 16 percent in 7-year notes, 11 percent in 10-year notes, 7 percent in 30-year bonds and 3 percent in TIPS.

Net Bill Issuance Projects \$43 billion Paydown

The survey projected net bill redemption of \$43 billion for the first quarter in 2010, compared to net redemption of \$203.0 billion in the fourth quarter of 2009 and a net issuance of \$166.9 billion in the first quarter of 2009. The wide range of responses received reflects the overall uncertainty for the economic recovery and Treasury's actions going forward.⁵ Gross bill issuance is expected to total nearly \$1.1 trillion in the first quarter, lower however than the \$1.36 trillion in 4Q'09 and the \$1.70 trillion recorded for 1Q'09. Overall consensus continues to be that issuance levels will gradually decline over time.

U.S. Treasury Yield Outlook – Curve Will Flatten Before Rates Rise Again

The survey forecasts benchmark Treasury yields will decrease going through the first quarter of 2010 before increasing again in the second quarter, relative to levels prevalent at the time the survey was taken.⁶ This trend reflects the uncertainty around the demand for relatively safe-haven Treasury debt as the government continues to inject the system with funds to prop up employment and the housing market, and the economy follows a rocky road to sustained growth. The Federal Reserve also plans on ending most of its federal purchase programs by the end of 1Q'2010, which may then drive demand for Treasuries in the near term down and push yields up.

The median forecast for the 10-year Treasury yield was 3.6 percent for the first quarter of 2010 and 3.8 percent for the second quarter of 2010. Projections for 10-year yields ranged from 3.5 to 4.1 percent in 1Q'10 and from 2.75 to 4.7 percent in 2Q'10. The median forecasts for the 30-year bond yield are 4.5 percent for the first quarter and 4.8 percent for the second quarter this year. Again, there was a narrower range of responses for first quarter 30-year projections, from 4.45 percent to 5.2 percent, than for the second quarter, which ranged from 3.5 to 5.6 percent. The wider yield ranges for 2Q'10 reflect the respondents' diverse assumptions and opinions

⁵ Net bill issuance projections for the first quarter of 2010 ranged from a net redemption of \$230 billion to a net issuance of \$140 billion. A net redemption, or negative net issuance, number may be interpreted as a net paydown of outstanding Treasury debt.

⁶ As of January 25, the 2-year note yield was 0.81 percent and the 10-year yield was 3.63 percent, and 30-year yield was ? percent..

about the economic progress. The 2-year Treasury note was forecast to yield 1.0 percent in the first quarter and 1.2 percent in the second quarter of 2010. The range around the first quarter 2-year yield projections was 0.75 percent to 1.5 percent, and again, was much broader for the second quarter, between 0.8 and 2.7 percent.

The survey projects a slight flattening of the yield curve in 1Q'10 before rates rise across the board in 2Q'10, as measured by the 2-year to 10-year Treasury yield spreads. These yield spreads hit the 2009 low of 190 basis points (bps) at the end of 1Q'09, and a high of 270 bps at the end of December; the average spread for all of 2009 was 233 bps. The Survey projects the 2-year to 10-year Treasury yield spread will be the same for both the first and second quarters of 2010, at 260 bps, but this is due to both 2- and 10-year yields rising by the same increment going into 2Q'10 (after the 10-year yield was estimated to fall quicker than the 2-year yield in 1Q'10).

Strong Economic Recovery, Inflation Continue to be Main Rate Upside Risks; Weak Employment, Economy, and Deflation the 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 below in Table 1). The dominant risks identified on the upside (higher-than-expected yields) are: a quicker-than-expected economic recovery (perhaps due to additional stimulus efforts) and ensuing inflation. The dominant risks identified on the downside (lower-than-expected yields) are: a weaker-than-expected economic rebound (perhaps due to continued high unemployment and the withdrawal of government support for the housing markets), causing more severe real estate deflation.

Federal Agency Issuance Expected to Rise; FHLBs Continue as Major Liquidity Provider

The survey forecasts total gross coupon issuance by the four largest Federal agencies of \$255 billion in the first quarter, compared to \$209 billion in the fourth quarter of 2009.⁷ Approximately 39 percent of the issuance volume is expected to come from the Federal Home Loan Banks (FHLBs), reflecting their continued importance as a reliable and lower-cost source of liquidity for home mortgage and other community lending needs. Fannie Mae and Freddie Mac are projected to each account for 25.5 percent of total agency issuance in the first quarter.

⁷ Includes Fannie Mae, Freddie Mac, the Federal Home Loan Banks (FHLBs), and the Federal Farm Credit Banks Funding Corporation.

Table 1. Summary of Risks to Rate Forecasts

	Risks to Upside	Risks to Downside
#1	Growth and/or inflation comes in much stronger than we expect. Combined with another year of heavy issuance, this would be a recipe for rates rising in a hurry.	Renewed weakness in economic growth due to a combination of lax job hiring and lending.
#2	We expect rates to drift higher near term, but to grind lower later. We believe 10s and the back-end of the curve should underperform as we approach end of QE.	Strong data prompts a large sell off in the front end, and curve flattens quickly.
#3	End of QE, and weaker Chinese economy causes less Treasury buying	Continuation of QE, weak employment, and sovereign risk.
#4	End of Fed purchase programs puts upward pressure on longer maturity yields from a supply/demand perspective, OR economy recovers quicker than expected but high unemployment politically keeps Fed from tightening, thus leading to inflation fears.	As government support for markets decreases, housing market declines more and economy falters.
#5	Inflation	Weaker economy, more dovish Fed
#6	Market is incapable of underwriting long dated supply without more concession. Inflation spikes higher. Another round of fiscal stimulus driven by erosion of state and local finances.	Real estate deflation worsens, driving down price of assets on bank balance sheets. Consumer continues to deleverage. Deflation ensues.
#7	NA	NA

Source: First Quarter 2010 SIFMA Government Forecast Survey

Agency Spreads Largely Expected to Rise in First Half 2010; Swap Spreads and LIBOR Also See Moderate Increases

The respondents expect agency yields and agency-to-Treasury yield spreads to increase in the first quarter of 2010 from fourth quarter 2009 levels. Respondents predict a 4 bps increase between 4Q'09 and 1Q'10 for 2-year agencies spreads, a 6.5 bps increase for 5-year agencies spreads, and a 11 bps increase for 10-year agencies spreads. Respondents also expect swap-to-Treasury yield spreads to rise through June of this year, albeit at a much more moderate pace. The one exception is for the 2-year swap spread to Treasuries, for which respondents actually see a decline of 3.6 bps between 4Q'09 and 1Q'10.

As for the three-month London Interbank Offered Rate (LIBOR), the Survey projects it will increase slightly throughout the first half of this year, to 0.3 percent in 1Q'10 and 0.4 percent in 2Q'10 from its 0.25 percent level at yearend 2009.

Most Recommend Neutral-to-Under Weight

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 favor an underweight recommendation and are summarized in Table 2.

Table 2. Distribution of Duration Weightings

	Strong Over	Over	Neutral	Under	Strong Under
0-3 yrs	0%	17%	50%	33%	0%
3-7 yrs	0%	17%	33%	50%	0%
7-10 yrs	0%	17%	50%	33%	0%
10-30 yrs	0%	17%	33%	50%	0%

Source: First Quarter 2010 SIFMA Government Forecast Survey; percent of total respondents

SIFMA's Government Securities Research Committee Forecast

Forecast numbers appear in bold

Issuance Projections	\$ Billions		
U.S. Treasury Borrowing¹	<u>4Q'09</u>		<u>1Q'10</u>
Net Coupon Issuance	362.5		460.0
Net Bill Issuance	(203.0)		(43.0)
Quarter end cash balance	82.0		50.0
U.S. Treasury Quarterly Gross New Issuance			
4 week Bill	448.4		300.0
13 week Bill	416.0		330.0
26 week Bill	425.0		350.0
52 week Bill	81.0		78.0
2 year Treasury Note	135.7		132.0
3 year Treasury Note	124.5		120.0
5 year Treasury Note	128.5		126.0
7 year Treasury Note	97.7		96.0
10 year Treasury Note	69.4		69.0
30 year Treasury Bond	43.2		44.0
Treasury Inflation-Indexed Securities	14.1		20.0
Federal Agency: Projected Total Gross Coupon Debt Issuance²			
Fannie Mae	57.4		65.0
Freddie Mac	43.1		65.0
Federal Home Loan Bank System - Office of Finance	89.2		100.0
Federal Farm Credit Banks Funding Corporation	19.3		25.0
		FY estimates	
Federal Budget Deficit Actual - FY2009		1,413.6	
Federal Budget Deficit Estimate - FY2010		1,290.0	
Federal Budget Deficit Estimate - FY2011		1,100.0	
Rates & Spreads Outlook	<u>12/31/09</u>	<u>3/31/10</u>	<u>6/30/10</u>
Interest Rates (End of Quarter in %Yield)			
2 year Treasury Note	1.1	1.0	1.2
5 year Treasury Note	2.7	2.5	2.7
10 year Treasury Note	3.8	3.6	3.8
30 year Treasury Bond	4.6	4.5	4.8
3 Month LIBOR	0.3	0.3	0.4
Spreads to Treasury (End of Quarter in Basis Points)			
2 year Agency Benchmark/Reference Notes ³	8.5	12.5	11.0
5 year Agency Benchmark/Reference Notes ³	17.5	24.0	26.0
10 year Agency Benchmark/Reference Notes ³	19.0	30.0	35.0
2 Year SWAP Spreads	28.6	25.0	25.5
5 Year SWAP Spreads	29.5	30.0	30.0
10 Year SWAP Spreads	13.2	13.5	19.0

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

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⁹ Previous survey reports may be found at www.sifma.org/research/govt-rates.shtml.