

Research

Government Forecast



The Securities Industry and Financial Markets Association¹ is pleased to report the results of its Quarterly Government Securities Issuance and Rates Forecast. The forecast reflects the responses to a survey² 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. Previous survey reports may be found at sifma.org/research.

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Net Total Issuance Higher, Gross Issuance Lower Than a Year Ago

The median survey response forecasts total net Treasury bill, note and bond issuance to be \$62 billion in the fourth quarter of this year,³ higher than both the third quarter and the fourth quarter a year ago. The year-over-year projected increase is consistent with the a higher budget deficit forecast for this fiscal year, following an extended period of lower deficits as a result of tax revenue growth. The gross Treasury issuance forecast, which is projected to be lower than last quarter, is affected by expected refundings of maturing and callable debt as well as Treasury's new cash needs.

Coupon Issuance

The median forecast for net new issuance of Treasury coupon securities is \$22 billion for this quarter compared to \$23.2 billion in the third quarter of 2007 and \$9.3 billion in the fourth quarter a year ago.⁴ This represents a more than doubling of the issuance volume compared to a year ago. Based on the median forecast, the committee believes the Treasury Department will finish the quarter with a cash position of

\$30 billion, compared to a balance of \$75.2 billion at the end of the third quarter of 2007, but even with the \$30.7 billion a year ago.⁵

The median forecast for gross nominal coupon issuance is expected to total \$119 billion this quarter, a decline from the \$178.1 billion the previous quarter and \$188.9 billion the fourth quarter a year ago. According to the survey, Treasury will issue \$12 billion of Treasury Inflation-Protected Securities (TIPS) this quarter compared to \$14 billion last quarter and the \$19 billion during the fourth quarter of 2006.

The median forecast for gross combined nominal coupon and TIPS issuance is \$131.0 billion in the fourth quarter of 2007 compared to \$192.1 billion in the third quarter and \$207.9 billion during the fourth quarter of 2006. Of the \$131 billion, approximately 41 percent will be 2-year nominal notes, 30 percent 5-year nominal notes, 16 percent 10-year nominal notes, 4 percent 30-year bonds and 9 percent TIPS. (Note that the Treasury stopped selling 3-year notes as of May 2007.)

continued on page 2

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¹ The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 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 5, 2007, subsequent to the announcement of the September monthly employment data. The Committee received responses from 9 firms represented on the committee. The Committee conducts this survey on a quarterly basis.

³ The dates and numbering of quarters are based on calendar year rather than fiscal years unless otherwise noted.

⁴ Panelist net coupon issuance projections for the fourth quarter of 2007 ranged from \$21.6 billion to \$34.1 billion.

⁵ The panelist end of the fourth quarter net cash position projections ranged from \$25 billion to \$68 billion.

Bill Issuance

The survey projects net bill issuance of \$40 billion for the fourth calendar quarter of this year compared to \$26 billion the third quarter⁶ and the net paydown of \$23.3 billion in the fourth quarter of last year. Gross bill issuance will total \$655 billion for the quarter, which is less than the \$926.3 billion in the third quarter and \$852.0 billion in the fourth quarter last year. The lower gross bill issuance projection suggests a lower volume of bills maturing this quarter.

Combining net coupon and bill issuance, the median survey response expects total net issuance of about \$62 billion of Treasury securities in the fourth quarter compared to \$49.2 billion last quarter and a net paydown of \$14.0 billion during the fourth quarter of 2006. Net total issuance for FY 07 was \$117.8 billion.

Budget Deficit Projection

The committee projects an FY 08 federal budget deficit of \$200 billion, higher than the FY 07 deficit of \$162.8 billion, which was the smallest deficit in five years. The higher deficit projection may reflect expectations of moderating tax revenue growth consistent with the consensus view of positive but below-trend economic growth over the coming year as the economy works through the effect of the extended housing downturn. Over this survey series, the survey's median projected deficit forecasts have tended to be conservative, i.e. higher than actual.

The FY 07 budget deficit came in lower than expected due to the significant rise in tax revenues generated by sustained economic and corporate profit growth. The rates of growth for both tax revenues and expenditure has been moderating since peak cyclical growth rates in FY 05. Total Federal government revenues grew by approximately 6.7 percent in FY 07 over FY 06 while expenditures increased by about 2.8 percent. Personal and corporate tax receipts for FY 07 were about 11.5 and 4.6 percent, respectively, ahead of FY 06. (The difference between total government revenue growth and personal and corporate tax receipt growth were lower levels of excise, unemployment and estate taxes compared to the previous fiscal year.)

U.S. Treasury Yield Outlook

The committee also forecasts the direction of benchmark interest rates. Relative to rates at the time the survey was taken, the median forecast projects the Treasury yields to decline slightly over the next couple quarters. (The 2-year note yield was 4.13 percent, and the 10-year yield was 4.69 percent at

the end of the survey period, October 11.) The survey period followed the announcement of monthly employment data on October 5. Since the survey period, Treasury benchmark yields declined as renewed credit market concerns have led to an investor "flight to quality." As of October 22, the 2-year note was yielding 3.86 percent and the 10-year note was yielding 4.41 percent..

Interest Rate and Yield Curve Forecast

The median forecast is for a 10-year Treasury yield of 4.60 percent at the end of the fourth quarter, remaining at that level at the end of the first quarter of next year. The 2-year Treasury will yield 4.00 percent at the end of the fourth quarter and 4.10 percent at the end of the first quarter of next year, according to the survey.⁷ The median forecast projects the 30-year bond yield to be 4.85 percent at the end of the fourth quarter and 4.80 at the end of the first quarter of next year.

In addition, the Committee expects that the shape of the yield curve will not change dramatically, steepening slightly over the next quarter and then flattening in the first quarter. Based on the median projection, the 2-year to 10-year Treasury yield spread will be 60 basis points at the end of the fourth quarter and 50 basis points at the end of the first quarter of next year.

Stronger Economic Growth, Higher Inflation are Upside Risks; Extended Housing Market Correction, Additional Credit Market Volatility are Downside Risks to the Interest Rate Forecast

The survey asked participants about risks to the forecast, or, events that could cause interest rates to move higher or lower than forecasted. The dominant risk that could push rates higher was the pace of economic growth re-accelerating faster than expected, and the expected rate of inflation or inflationary concerns increasing as a result of a faster growing economy. Stronger than expected economic growth would have the effect of driving up real rates. Conversely, the dominant risk to the forecast identified by the analysts that could push rates lower is a sharper and longer than expected housing sector deterioration spilling over into other sectors, resulting in substantial economic deceleration lowering the demand on resources and depressing bond yields. An additional downside scenario to the rates forecast is another round of credit market turbulence and risk repricing leading to a "flight to quality," increasing the demand for Treasury securities which also would have the effect of reducing benchmark yields.

⁶ The panelist net bill issuance projections for the fourth quarter ranged from \$11 billion to \$55 billion.

⁷ The range of projections for the 10-year Treasury yield at the end of the fourth quarter 2007 ranged from 4.20 percent to 4.80 percent and the range of projections for the 2-year at the end of the fourth quarter ranged from 3.60 percent to 4.30 percent.

Outlook for New Issuance by the Federal Agencies

The survey forecasts total gross note issuance by the four largest Federal Agencies to be \$180 in the fourth quarter compared to \$184 billion in the third quarter.⁸ The projected slightly lower debt issuance for the quarter suggests the view that the continuing housing correction will cut into mortgage origination volumes. The relatively modest magnitude of the decline may reflect the increased agency financing cost advantage, especially relative to private label MBS, as a result of the fallout from subprime market trends.

Agency to Treasury Spreads Expected to Be Stable

Based on the median response, the panelists expect agency-to-Treasury spreads to remain fairly stable across maturity sectors in the fourth quarter, but with the shorter 2-year spread tightening by 3 basis points by the end of the first quarter of 2008. Swap spreads are also expected to remain relatively unchanged across maturity sectors. In general, spreads move in the same direction as Treasury yields and thus are affected by a number of factors, including monetary policy. The stable agency spread outlook reflects a view towards greater stability in the credit market environment over the next few quarters compared to the heightened market volatility and credit repricing in the third quarter. Credit markets have stabilized somewhat since the disruptions in August and September, which culminated in the Federal Open Market Committee's (FOMC) 50 basis Fed funds rate cut in mid-September.

Affected by troubles in the asset-backed commercial paper market last quarter, recent volatility in the money markets had led to a rise in the closely followed LIBOR (London Inter-Bank Borrowed Rate) to record levels. The median forecast has the 3-month LIBOR at 4.85 percent at the end of the year, declining to 4.70 percent at the end of the first quarter next year compared to the present 5.23 percent (and 5.65 percent a month ago), reflecting the expectation of a return to more normal and stable conditions in the money markets over the next two quarters.

Survey Recommends Shortened Duration Positions

The survey asks the committee for their recommendations to investors for model portfolio allocations compared to the current portfolio weighting across the U.S. Treasury yield curve. The strong Committee consensus generally recommends overweighting shorter duration sectors and underweighting longer durations. The recommendations are consistent with a market expectation for responsive and credible Fed policy and greater uncertainty about the outlook for longer benchmark yields. The duration strategy recommendations are also

consistent with the expectation of a decline in the short-term (2-year) benchmark yield.

About 71 percent recommended overweighting the 0-to-3 year duration sector, 14 percent recommended an underweight, and the balance, or 15 percent, recommended neutrality. About 57 percent recommended overweighting the 3-to-7 year duration sector, 14 percent recommended an underweight, and the balance, or 29 percent, were recommending neutrality. Conversely, approximately 14 percent of the respondents recommended overweighting the 7-to -10 year sector, 43 percent recommended an underweight, and the additional 43 percent recommended neutrality. About 17 percent of the survey respondents recommended overweighting, and 67 percent recommended underweighting the 10-to-30 year sector, with the balance recommending neutrality.

The members of Securities Industry and Financial Markets Association's Government Securities Research, Analysis and Strategist Committee consist of individuals from the following firms:

ABN AMRO Bank
Barclays Capital Inc.
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CitiGroup Global Markets Inc.
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Deutsche Bank Securities Inc.
Fourth Tennessee Capital Markets
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Merrill Lynch Government Securities Inc.
Mizuho Securities USA Inc.
Morgan Stanley & Co. Incorporated
Nomura Securities International, Inc.
RBS Greenwich Capital
UBS Warburg LLC.

Steven Davidson, Staff Advisor
Robert Toomey, Staff Advisor

⁸ 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	2007:Q3	\$ Billions	2007:Q4
U.S. Treasury Borrowing¹			
Net Coupon Issuance	23		22
Net Bill Issuance	26		40
Quarter end cash balance	75		30
U.S. Treasury Quarterly Gross New Issuance			
4 week Bill	297		207
13 week Bill	337		239
26 week Bill	292		210
2 year Treasury Note	66		54
5 year Treasury Note	48		39
10 year Treasury Note	28		21
30 year Treasury Bond	13		5
Treasury Inflation-Protected Securities	14		12
Federal Agency: Projected Total Gross Coupon Debt Issuance^{2,3}			
Fannie Mae	34		34
Freddie Mac	30		41
Federal Home Loan Bank System - Office of Finance	107		95
Federal Farm Credit Banks Funding Corporation	13		10
Federal Budget Deficit Estimate - FY	163 (FY07)		200 (FY08)

Rates & Spreads Outlook	Sept. 2007	% Yields Dec. 2007	Mar. 2008
Interest Rates (End of Quarter in % Yield)			
2 Year Treasury Note	3.98	4.00	4.10
5 Year Treasury Note	4.24	4.25	4.40
10 Year Treasury Note	4.59	4.60	4.60
30 Year Treasury Bond	4.84	4.85	4.80
3 Month LIBOR	5.23	4.85	4.70
2 Year Agency Benchmark/Reference Notes ⁴	39	41	38
5 Year Agency Benchmark/Reference Notes ⁴	43	42	43
10 Year Agency Benchmark/Reference Notes ⁴	44	42	43
2 Year SWAP Spreads	60	65	56
5 Year SWAP Spreads	58	63	58
10 Year SWAP Spreads	56	61	60

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