Research
Government Forecast

SIFMA
Securities Industry and Financial Markets Association

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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. Previous survey reports may be found at sifma.org/research.

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

The median survey response forecasts total net Treasury bill, note and bond issuance of $125 billion in the first quarter of this year,[3] 267 percent higher than the fourth quarter and 56 percent higher than a year ago. The year-over-year projected increase is consistent with 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 $20 billion for this quarter compared to $41 billion in the fourth quarter of 2007 and $37 billion in the first quarter a year ago.[4] This represents a decline of 46 percent from the issuance volume in the first quarter a year ago. Based on the median forecast, the committee believes the Treasury Department will finish the quarter with a cash position of $25 billion, compared to a balance of $57 billion at the end of the fourth quarter of 2007 and $6 billion a year ago.[5]

Gross nominal coupon issuance is expected to total $138 billion this quarter, a decline from $158 billion the previous quarter and $188 billion the first quarter a year ago. According to the survey, Treasury will issue $16 billion of Treasury Inflation-Protected Securities (TIPS) this quarter compared to $12 billion last quarter and the $20 billion during the first quarter of 2007.

The median forecast for gross combined nominal coupon and TIPS issuance is $154 billion in the first quarter of 2008 compared to $170 billion in the fourth quarter and $208 billion during the first quarter of 2007. Of the $154 billion, approximately 43 percent will be 2-year nominal notes, 27 percent 5-year nominal notes, 14 percent 10-year nominal notes, 6 percent in 30-year bonds and 10 percent TIPS.

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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 January 4, 2008, subsequent to the announcement of the December monthly employment data. The Committee received responses from 10 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 first quarter of 2008 ranged from $8.3 billion to $30 billion.*

[5] *The panelist end of the first quarter net cash position projections ranged from $10 billion to $45 billion.*

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Bill Issuance

The survey projects net bill issuance of $105 billion for the first calendar quarter of this year, compared to a net paydown of $7 billion the fourth quarter[6] and net issuance of $43 billion in the first quarter of last year. Gross bill issuance will total $834 billion for the quarter, less than the $907 billion in the fourth quarter and $906 billion in the first 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 $125 billion of Treasury securities in the first quarter compared to $34 billion last quarter and $80 billion during the first quarter of 2007. Net total paydown for FY 07 was $118 billion, reflecting the lower budget deficit in FY 07.

Budget Deficit Projection

The committee projects a federal budget deficit for FY 08 of $228 billion, higher than the FY 07 deficit of $162.8 billion, which was the smallest deficit in five years, and also higher than the Committee's forecast of $200 billion in the previous quarterly survey. The higher deficit projection reflects expectations of positive but below-trend economic growth over the coming year as the economy works through the effect of the extended housing sector weakness and credit market volatility. Through the first three months of the current fiscal year, the FY 08 deficit was approximately $106 billion compared to $81 billion through the first three months of FY 07. Over this survey series, the survey's median projected deficit forecasts have tended to be conservative, i.e. higher than actual. The Office of Management and Budget (OMB) the Congressional Budget Office projected deficits of $258 billion and $155 billion respectively for FY 08 during the summer. Both forecasts are due to be updated within the next several weeks.

The FY 07 budget deficit came in lower than many forecasts due to the significant rise in tax revenues generated by sustained economic growth and corporate profits. The rates of tax revenue and expenditure growth have 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.) Through the first three months of this fiscal year, receipts are running about 5 percent ahead of last year while expenditures are about 7 percent higher.

U.S. Treasury Yield Outlook: Rates to Increase Modestly over the First Half of the year as the Economy Begins to Firm Up

The committee also forecasts the direction of benchmark interest rates. Relative to rates at the time the survey was taken, the median forecast projects Treasury yields to rise slightly over the next couple quarters from the historically low current levels. (The 2-year note yield was 2.71 percent, and 10-year yield was 3.91 percent at the end of the survey period, January 10.)

Interest Rate and Yield Curve Forecast

The median forecast is for a 10-year Treasury yield of 3.98 percent at the end of the first quarter and 4.15 percent at the end of the second quarter. The 2-year note will yield 2.90 percent at the end of the first quarter and 3.00 at the end of the second quarter, according to the survey.[7] The 2-year Treasury yield forecast suggests the view at the time of the survey that the Federal Open Market Committee (FOMC) would bring the target Fed funds rate below the then prevailing 4.25 percent during the first half of the year. (On January 22 the Fed lowered the target Fed Funds rate to 3.50 percent.) The median forecast projects the 30-year bond yield to be 4.40 percent at the end of the first quarter and 4.60 percent at the end of the second quarter.

In addition, the Committee expects that the shape of the yield curve, which has steepened significantly over the last several months, will not change dramatically over the next few quarters, flattening slightly over the next quarter and moving back in the second quarter to the current 2-year to 10-year spread. At the end of the third quarter, the 2-year to 10-year Treasury yield spread was about 61 basis points compared to 120 basis points during the survey period. Based on the median projection, the 2-year to 10-year Treasury yield spread will be 108 basis points at the end of the first quarter and 115 basis points at the end of the second quarter.

Resilient Economy, Higher than Anticipated Inflation are Upside Risks, Weaker U.S., Global Economy 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 expected. The dominant risks indentified on the

[6] *The panelist net bill issuance projections for the first quarter ranged from $72 billion to $132 billion.*

[7] *The range of projections for the 10–year Treasury yield at the end of the first quarter 2008 ranged from 3.65 percent to 4.50 percent and the range of projections for the 2-year at the end of the first quarter ranged from 2.50 percent to 3.40 percent.*

upside at the short end of the yield curve were the a faster-than-expected economic re-acceleration and stronger consumer spending, leading to less rate-cutting by the Federal Reserve. The upside risk on the longer end of the curve was inflation or inflationary concerns increasing as a result of a faster growing economy. Conversely, the dominant downside risk to the forecast identified by the analysts is a weaker than anticipated economy in the U.S. spilling over to slow the broader global economy and a more aggressive rate-cutting response from the Federal Reserve.

Outlook for New Issuance by the Federal Agencies

The survey forecasts total gross note issuance by the four largest Federal Agencies to be $235 in the first quarter compared to $257 billion in the fourth quarter.[8] The projected slightly lower debt issuance for the quarter suggests the view that the continuing housing sector deterioration will cut into mortgage origination volumes. The relatively modest magnitude of the decline reflects the increased agency financing cost advantage, especially relative to nonagency mortgage-backed securities (MBS).

Agency to Treasury Spreads Expected to Tighten

Based on the median response, the panelists expect agency-to-Treasury spreads and swap spreads to tighten over the next few quarters from the levels at the time the survey was taken. Agency spreads tend move in the same direction as Treasury yields and are affected by a number of factors, including monetary policy. The tighter agency spread outlook reflects a view towards improved credit market conditions during the first half of 2008, following the current period of heightened money market volatility, reduced interbank funding liquidity, and credit risk repricing.

Money markets have begun to recover in response to the Fed's lending through the Term Auction Facility program and the Federal Open Market Committee (FOMC)'s Fed funds rate cuts. The Treasury-to-LIBOR spread was at a historically wide level in December. The 3-month LIBOR (London Inter-Bank Borrowed Rate) declined by 60 basis points to 4.51 percent over the month period ending January 9. The median projection has the 3-month LIBOR declining further to 3.95 percent by the end of the first quarter and 3.60 percent by mid-year, reflecting the expectation of a return to more normal and stable conditions in the money markets over the next two quarters.

Survey Respondents' Duration Recommendation Moving Closer to Neutrality, Continue to Favor Keeping Duration Inside of 10 Years

The survey asks the committee for their recommendations to investors for model portfolio allocations compared to the current portfolio weighting across the maturity spectrum of the U.S. Treasury yield curve. The Committee consensus continues to generally favor shorter and intermediate duration sectors. The strong preference for shorter duration portfolios found in the last quarterly survey, however, has moderated. The recommendations are consistent with a market view of responsive and credible Fed policy.

Approximately 44 percent favored overweighting the 0 to 3 year sector, 33 percent recommended underweighting and the balance recommend neutrality. About a third of the respondents recommended overweighting the 3-to-7 year maturity sector, a third recommended underweighting and a third recommended neutrality . Approximately 44 percent of the respondents recommended overweighting the 7-to -10 year sector, 33 percent recommended underweighting, and the remaining 22 percent recommended neutrality. Conversely, about 11 percent of the survey respondents recommended overweighting and 67 percent recommended underweighting the 10-to-30 year sector, with the balance recommending neutrality.

[8] *Includes Fannie Mae, Freddie Mac, the Federal Home Loan Banks and the Federal Farm Credit Banks Funding Corporation. Note that, at the time of this survey, first quarter issuance volumes had not been released.*

SIFMA's Government Securities Research Committee Forecast

Forecast numbers appear in bold

Issuance Projections	$ Billions 2007:Q4	2008:Q1
U.S. Treasury Borrowing[1]		
Net Coupon Issuance	41	**20**
Net Bill Issuance	(7)	**105**
Quarter end cash balance	57	**25**
U.S. Treasury Quarterly Gross New Issuance		
4 week Bill	282	**294**
13 week Bill	318	**285**
26 week Bill	307	**255**
2 year Treasury Note	75	**66**
5 year Treasury Note	47	**42**
10 year Treasury Note	28	**21**
30 year Treasury Bond	8	**9**
Treasury Inflation-Protected Securities	12	**16**
Federal Agency: Projected Total Gross Coupon Debt Issuance[2,]		
Fannie Mae	43	**45**
Freddie Mac	35	**60**
Federal Home Loan Bank System - Office of Finance	153	**120**
Federal Farm Credit Banks Funding Corporation	26	**10**
Federal Budget Deficit Estimate - FY	168 (FY07)	**228 (FY08)**

Rates & Spreads Outlook	Dec. 2007	% Yields Mar. 2008	Jun. 2008
Interest Rates (End of Quarter in % Yield)			
2 Year Treasury Note	3.05	**2.90**	**3.00**
5 Year Treasury Note	3.44	**3.30**	**3.50**
10 Year Treasury Note	4.02	**3.98**	**4.15**
30 Year Treasury Bond	4.45	**4.40**	**4.60**
3 Month LIBOR	4.70	**3.95**	**3.60**
2 Year Agency Benchmark/Reference Notes[4]	51	**55**	**50**
5 Year Agency Benchmark/Reference Notes[4]	52	**55**	**53**
10 Year Agency Benchmark/Reference Notes[4]	52	**55**	**54**
2 Year SWAP Spreads	77	**70**	**62**
5 Year SWAP Spreads	76	**66**	**62**
10 Year SWAP Spreads	66	**60**	**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*