Research
Government Forecast

SIFMA
Securities Industry and Financial Markets Association

April 2008

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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.

Second Quarter Total Net Issuance Higher Than a Year Ago on Larger Budget Deficit Projection, Lower than the First Quarter Due to Seasonal Factors

The median survey response forecasts net Treasury bill, note and bond issuance to be -$500 million[3] in the second quarter of this year,[4] lower than the first quarter of 2008, but higher than the second quarter a year ago. The year-over-year projected increase (that is, lower paydown) is consistent with the higher budget deficit forecast for this fiscal year, following an extended period of lower deficits as a result of significant tax revenue growth. The lower net issuance volume compared to the first quarter is primarily the result of the seasonal effect of tax revenue inflows peaking in the second quarter which includes the April 15 tax deadline. 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 $47.0 billion for the second quarter compared to $36.5 billion in the first quarter of 2008 and $25.4 billion in the second quarter a year ago.[5] This represents an increase of 85.0 percent from the net issuance volume in the second quarter of 2007. Based on the median forecast, the committee believes the Treasury Department will finish the quarter with a cash position of $45.0 billion, compared to a balance of $46.1 billion at the end of the first quarter of 2008 and substantially higher than the $25.2 billion a year ago.[6]

The median forecast for gross nominal coupon issuance is expected to total $180.0 billion this quarter, a decline from the $203.8 billion the previous quarter and from $184.4 billion the second quarter a year ago. According to the survey, Treasury will issue $14.0 billion of Treasury Inflation-Protected Securities (TIPS) in the second quarter of 2008 compared to $16.0 billion in the first quarter of 2008 and the second quarter of 2007.

The median forecast for gross combined nominal coupon and TIPS issuance is $194.0

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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] A negative net issuance is the equivalent of a paydown.

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

[5] Panelist net coupon issuance projections for the second quarter of 2008 ranged from $42 billion to $60 billion.

[6] The panelist end of the second quarter net cash position projections ranged from $30 billion to $84 billion.

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billion in the second quarter of 2008 compared to $219.8 billion in the first quarter and $200.4 billion in the second quarter of 2007. Of the $194.0 billion, approximately 47 percent will be 2-year nominal notes, 30 percent 5-year nominal notes, 13 percent 10-year nominal notes, 3 percent in 30-year bonds and 7 percent TIPS.

Bill Issuance

The survey projects net bill paydown of $47.5 billion[7] for the second calendar quarter of this year compared to $45.5 billion net issuance the first quarter[8] and a $258.0 billion paydown in the second quarter of last year. The linked-quarter projected shift from net bill issuance to net bill paydown is the result of lower demand for cash during the second quarter when the Treasury generally pays down a portion of the outstanding bill volume. Gross bill issuance will total $799.0 billion for the quarter, which is less than the $987.4 billion in the first quarter but higher than the $746.3 billion in the second quarter last year. The gross bill issuance projection relative to net bill issuance suggests a lower volume of bills maturing this quarter compared to the first quarter, but higher than the second quarter a year ago.

Combining the net coupon and bill issuance forecasts, the median survey response expects a net paydown of about $500 million of Treasury securities in the second quarter compared to net issuance of $82.0 billion last quarter and a net paydown $232.7 billion during the second quarter of 2007. Based on the median projection for this quarter and actual volumes for the first two quarters of Fiscal Year 2008 (FY 08), net issuance for the first three quarters of FY 08 is expected to be $15.3 billion compared to a net paydown of $167.0 billion for the comparable period of FY 07, reflecting the lower budget deficit in FY 07 compared to FY 08 expectations.

Budget Deficit Projection

The committee projects a federal budget deficit for FY 08 of $413 billion, higher than the FY 07 deficit of $168 billion, which was the smallest deficit in five years. The committee's budget deficit forecast in this current survey is higher than the committee's forecast of $228 billion in the previous quarterly survey. The higher deficit projection reflects a slower economic growth outlook as the economy works through the effects of the extended housing sector weakness and credit market displacement. Through the first half of the current fiscal year, the FY 08 deficit was approximately $310 billion compared to $264 billion through the first half 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) is projecting a $410 billion deficit, and the Congressional Budget Office updated their to $357 billion deficit for FY 08 to incorporate the stimulus package.

The FY 07 budget deficit came in lower due to the significant rise in tax revenues generated by sustained economic growth and corporate profits. Both the rate of tax revenue and expenditure growth has been moderating since peak cyclical growth rates in FY 05. Through the first six months of this fiscal year, the receipts are running about 2.2 percent ahead of last year, with corporate tax receipts 15 percent below last year on a fiscal year-to-date basis and individual tax receipts up by 5 percent. Year-to-date expenditures are about 5.7 percent higher.

U.S. Treasury Yield Outlook: Shorter Maturity Yields Decline, Longer Term Yields Up Modestly, Yield Curve to Continue to Steepen

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 2-year Treasury yield to decline and 10-year yield to rise slightly over the next couple quarters from historically low current levels. (The 2-year note yield was 1.77 percent, and 10-year yield was 3.49 percent at the end of the survey period, April 10.) The survey period followed the announcement of monthly employment data on April 4.

Interest Rate and Yield Curve Forecast

The median forecast is for a 10-year Treasury yield of 3.55 percent at the end of the second quarter and 3.90 percent at the end of the third quarter. The median forecast projects the 30-year bond yield to be 4.50 percent at both the end of the second quarter and at the end of the third quarter. The 2-year Treasury note will yield 1.45 percent at the end of the second quarter and 1.55 percent at the end of the third quarter, according to the survey.[9] The 2-year Treasury yield forecast may be suggesting that the Federal Open Market Committee (FOMC) will continue to reduce the target Fed funds rate.

In addition, the committee expects the shape of the yield curve to continue to steepen over the next few quarters from the current 2-year to 10-year Treasury yield spread. It should be noted that the yield curve has steepened significantly over the

[7] *A negative net issuance may be interpreted as a net pay down of outstanding Treasury debt.*

[8] *The panelist net bill issuance projections for the second quarter ranged from -$118 billion to $80 billion.*

[9] *The range of projections for the 10–year Treasury yield at the end of the second quarter 2008 ranged from 3.20 percent to 3.75 percent and the range of projections for the 2-year at the end of the second quarter ranged from 1.00 percent to 1.80 percent.*

last several months. At the end of 2007, the 2-year to 10-year Treasury yield spread was about 98 basis points compared to 172 basis points during the survey period. Based on the median projection, the 2-year to 10-year Treasury yield spread will be 210 basis points at the end of the second quarter and have a 235 basis point spread at the end of the third quarter. The steeper yield curve suggests continued heightened investor risk sensitivity.

Credit Market Strengthening, Higher than Anticipated Inflation are Upside Risk; Weaker U.S., Global Economy and Extended Credit Crunch 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 projected. The three dominant risks identified on the upside were credit market stability and improved financial conditions which would boost economic growth, rising inflation and inflationary expectations and further depreciation of the dollar. All of these upside risks would result in less rate-cutting by the Federal Reserve. Conversely, the dominant downside risks to the forecast identified by the analysts were greater-than-expected recessionary pressures spilling over to the broader global economy, a sharper credit crunch and event risk in the financial markets. The result would be a lower demand on resources, and thus bond yields and would generate an additional response from the Federal Reserve.

Federal Agency Issuance to be Lower

The survey forecasts total gross note issuance by the four largest Federal Agencies to be $346.4 in the second quarter compared to $445.4 billion in the first quarter.[10] Almost half of the issuance volume is expected to come from the Federal Home Loan Banks (FHLBs), as the FHLBs continue to be an important source of bank liquidity during the credit market dislocation. The lower agency issuance volume reflects an expectation that mortgage origination activity will remain subdued as a result of tighter underwriting and the weak housing market. The relatively modest magnitude of the decline reflects the agency financing cost advantage relative to nonagency mortgage-backed securities (MBS) and expanded mortgage purchasing authority including the temporary increase in the conforming loan limit. The non-agency prime MBS to agency MBS spread remains at a historically wide level, well above 125 basis points. The 30-year FNMA mortgage rate of 5.59 percent as of April 10 has declined by 50 basis points over the last month.

Agency to Treasury Spreads Expected to Tighten

Based on the median response, the panelists expect agency-to-Treasury spreads to tighten over the next few quarters from the levels at the time the survey was taken. The respondents expect spreads to Treasuries to tighten across the maturity spectrum. In general, spreads move in the same direction as Treasury yields and thus are affected by a number of factors, including monetary policy. The tighter agency spread outlook also indicates an implicit view of improved credit market conditions later in the year.

Money markets have begun to show some signs of recovery in response to the Fed's lending through the Term Auction Facility program introduced in December and, more recently, the Treasury Securities Lending Facility and Primary Dealer Credit Facility programs. LIBOR (London Inter-Bank Offered Rate) has come down from historically high levels at the end of last year and earlier this year but remains elevated and volatile. The 3-month LIBOR has declined to 2.70 percent as of April 10, or by 17 basis points, over the last month. The median projection has the 3-month LIBOR declining further to 2.10 percent by the end of the second quarter and to 2.00 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 Recommend Shorter Portfolio Durations

The survey asks the panelists 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 strongly favors short duration sectors. The recommendations are consistent with the forecast steeper yield curve as well as a market view of credible Fed policy and aggressive responses to prolonged credit market dislocation.

Approximately 80 percent of the survey respondents favored overweighing the 0- to 3-year sector, and 20 percent recommended an underweight. About 20 percent of the respondents recommended overweighting, 20 percent recommended underweighting and the balance recommended neutrality for the 3- to 7-year duration sector. Approximately 20 percent of the respondents recommended overweighting the 7- to 10-year sector, while 50 percent recommended an underweight, and the additional 30 percent recommended neutrality. Only 10 percent of the survey respondents recommended overweighting, and 70 percent recommended underweighting the 10- to 30-year sector, with 20 percent recommending neutrality.

[10] *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**	
	2008:Q1	**2008:Q2**
U.S. Treasury Borrowing[1]		
Net Coupon Issuance	36	**47**
Net Bill Issuance	46	**(48)**
Quarter end cash balance	46	**45**
U.S. Treasury Quarterly Gross New Issuance		
4 week Bill	327	**240**
13 week Bill	308	**299**
26 week Bill	313	**260**
2 year Treasury Note	88	**90**
5 year Treasury Note	54	**59**
10 year Treasury Note	29	**25**
30 year Treasury Bond	13	**6**
Treasury Inflation-Protected Securities	19	**14**
Federal Agency: Projected Total Gross Coupon Debt Issuance[2]		
Fannie Mae	93	**78**
Freddie Mac	94	**84**
Federal Home Loan Bank System - Office of Finance	217	**163**
Federal Farm Credit Banks Funding Corporation	40	**22**
Federal Budget Deficit Estimate - FY	168 (FY07)	**413 (FY08)**

		% Yields	
Rates & Spreads Outlook	**Mar. 2008**	**Jun. 2008**	**Sept. 2008**
Interest Rates (End of Quarter in % Yield)			
2 Year Treasury Note	1.58	**1.45**	**1.55**
5 Year Treasury Note	2.44	**2.40**	**2.80**
10 Year Treasury Note	3.41	**3.55**	**3.90**
30 Year Treasury Bond	4.29	**4.50**	**4.50**
3 Month LIBOR	2.69	**2.10**	**2.00**
2 Year Agency Benchmark/Reference Notes[3]	71	**61**	**55**
5 Year Agency Benchmark/Reference Notes[3]	86	**69**	**62**
10 Year Agency Benchmark/Reference Notes[3]	67	**66**	**62**
2 Year SWAP Spreads	88	**79**	**70**
5 Year SWAP Spreads	86	**80**	**75**
10 Year SWAP Spreads	66	**65**	**63**

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*