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

Expect Greater Issuance of Bills and TIPS; Yield Curve to Steepen

Issuance Forecasts

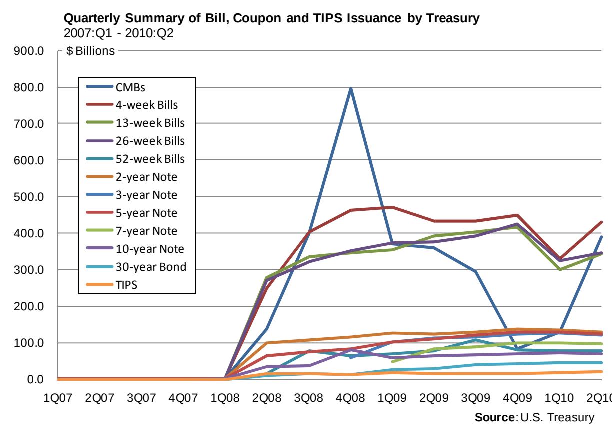
TOTAL ISSUANCE OUTLOOK The SIFMA Quarterly Issuance Survey[1] forecast total net Treasury bill, note and bond issuance to be $399.0 billion in the third quarter of 2010, compared with the net $343.6 billion issued (and $351.0 billion estimated in SIFMA's 2Q'10 issuance survey[2]) in the second quarter and $392.5 billion issued in the third quarter of 2009 (all actuals include cash management balances).

Excluding the cash management bills (CMBs), net issuance, or gross issuance less redemptions, was $(45.4) billion in the second quarter, compared to $353.2 billion in 1Q'10. This significant drop in net issuance reflects the increased use of short-term CMBs in the second quarter, up from approximately 7% of total gross Treasuries issuance in 1Q'10 to 18% in 2Q'10. The gross issuance of CMBs jumped nearly 200 percent from 1Q'10 to 2Q'10, which may be partly due to the increase in Treasury's Supplementary Financing Program (SFP) from $5 billion to $200 billion in late February, but also partially offset by a 47 percent jump in gross bill redemptions over this same time horizon. The total net issuance of $343.6 billion in 2Q'10 was in-line with Treasury's May borrowing estimate of $340 billion.

Overall, the issuance of shorter-term T-bills is expected to rise and longer-term coupon issuance is expected to fall in 3Q'10. The expected rise of total debt issuance in the third quarter may reflect increasing worries regarding stagnant unemployment, a cooling economic recovery, deflationary pressures, and the potential need for additional stimulatory measures by the U.S. government.

In addition, with the signing of the regulatory reform into law on July 21, increased uncertainty may build as regulators and the industry work to dissect hundreds of implementation issues in the coming months and years. Broad industry concerns revolve around the continued constriction of credit availability, hoarding of cash, and stagnant hiring, which would further drive market volatility and drag on the economic upturn.

Table 1. Quarterly Summary of Treasury Issuance



TREASURY COUPON ISSUANCE The median forecast for net new issuance of Treasury coupon securities (notes and bonds) is $376 billion for the third quarter, over 7 percent below both 2Q'10's net issuance of $404.5 billion and 3Q'09's $406.5 billion.[3] In addition, survey respondents believe that Treasury will finish the third quarter with a cash position of $272.5 billion, which accounts for the SFP increase to $200 billion, as noted earlier.[4] Treasury's May estimate for the end-June 2010 cash balance (including the $200 billion in SFP) was $280 billion and is $270 billion for end-September.

The third quarter 2010 forecast for gross coupon issuance is $531 billion, nearly 12 percent below the $601.6 billion issued in the second quarter and still 7.7 percent under 3Q'09's $575.1 billion issued.

The median forecast for gross combined coupon and TIPS issuance in the third quarter is $559 billion, more than 7 percent below the $601.5 billion in 2Q'10 and a 2.8 percent drop from 3Q'09's $575.1

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[1] The survey was conducted beginning on July 7, 2010 and ending on July 20, 2010. Survey results are medians and the dates and numbering of quarters are based on calendar year rather than fiscal year unless otherwise noted. A description of the participants is provided on page 5. Previous survey reports may be found at http://www.sifma.org/research/research.aspx?ID=10342.

[2] SIFMA's 2Q'10 Government Forecast Survey results can be found here.

[3] Net coupon issuance projections for the third quarter of 2010 ranged from $208 billion to $385 billion.

[4] Net cash position projections for the end of the third quarter 2010 ranged from $180 billion to $300 billion.

billion. Approximately 20 percent is expected to be in 2-year notes, 19 percent in 3-year notes, 20 percent in 5-year notes, 16 percent in 7-year notes, 12 percent in 10-year notes, 8 percent in 30-year bonds and 5 percent in TIPS.

AGENCIES' COUPON ISSUANCE The survey forecasts total gross coupon issuance by the four largest Federal agencies of $327 billion in the third quarter, compared to $232.1 billion in 2Q'10, a 41 percent increase.[5] A report by Treasury on the potential reorganization of mortgage giants Fannie Mae and Freddie Mac is expected to be released in early 2011, as the new regulatory reform legislation excluded any mention of definite solutions for the two agencies. Potential proposals range widely, from abolishing the two agencies to continuing their current structure to establishing a mortgage insurance fund or creating a covered bond market in the U.S. Approximately 40 percent of 3Q'10's issuance volume is expected to come from the Federal Home Loan Banks (FHLBs), 25.1 percent from Fannie Mae, 27.5 percent from Freddie Mac, and the remaining 7 percent from the Farm Credit System Banks.

T-BILL ISSUANCE The survey projects a net bill issuance of $23 billion for the third quarter, compared to a net redemption of $61 billion in 2Q'10 and similarly a $14 billion net redemption in 3Q'09. Responses received[6] forecast only bill issuance and no redemptions, suggesting that bills will play a more dominant role in Treasury's debt management plan, at least in the near-term.

Gross bill issuance is expected to be approximately $1.39 trillion in the third quarter, greater than the $1.19 trillion of regular series bills issued in the second quarter, but less than the $1.58 trillion of total bills (including CMBs) that were issued in 2Q'10. Fluctuations in overall bill issuance will likely be determined by changes in CMB auctions and maturities over the next quarter. Treasury previously announced in its May quarterly refunding statement that it plans to decrease the sizes of coupon auctions going forward.

TIPS Survey respondents forecast Treasury will issue $28 billion of Treasury Inflation-Protected Securities (TIPS) in 3Q'10, over 4 percent greater than the $19.8 billion issued in 2Q'10. TIPS are expected to account for a greater percentage of future total marketable debt. In its May refunding statement, Treasury announced that it plans to increase the frequency of TIPS auctions going forward.

U.S. Treasury Yield Outlook

The survey forecasts benchmark Treasury yields will increase going through the third as well as fourth quarters of 2010 relative to levels prevalent at the time the survey was compiled.[7] However, this increase is from dramatically lower baseline yield levels during the second quarter, than when the previous survey was completed.[8] A combination of international sovereign debt worries, deterioration in some housing markets, and stubbornly high unemployment rates contributed to increased market volatility and uncertainty throughout the second quarter, driving the demand for relatively safe haven Treasuries.

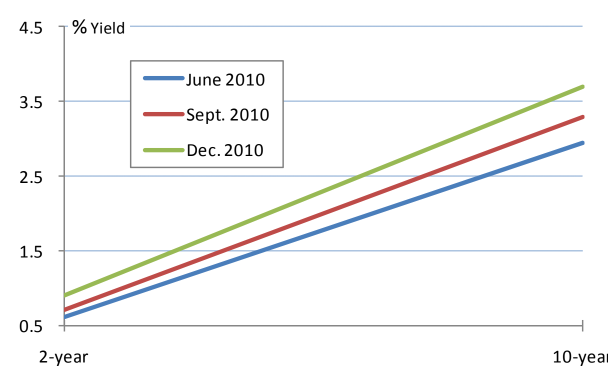
Table 2. Treasury Yield Projections and Ranges

	June 30, 2010	Sept. 30, 2010E	Dec. 31, 2010E
2 year Treasury Note	0.62	**0.7** (0.4 - 1.1)	**0.9** (0.6 - 1.4)
5 year Treasury Note	1.79	**2.0** (1.4 - 2.5)	**2.3** (1.6 - 2.8)
10 year Treasury Note	2.95	**3.3** (2.7 - 3.7)	**3.7** (2.9 - 3.9)
30 year Treasury Bond	3.91	**4.2** (3.7 - 4.6)	**4.4** (3.9 - 4.8)
3 Month LIBOR	0.53	**0.6**	**0.7**

Source: Third Quarter 2010 SIFMA Government Forecast Survey

The survey projects a 27 basis points (bps) steepening of the yield curve in 3Q'10, as measured by the 2-year to 10-year Treasury yield spreads. The 10-year yield is expected to rise more quickly than the 2-year yield. The respondents predict the 2-year to 10-year Treasury yield spread will be 260 bps at the end of the third quarter from 233 bps at the end of June, and 280 bps at the end of this year (see Tables 2 and 3 below).

Table 2. Projected 2-Year to 10-Year Treasury Yield Curve Movement



Source: Third Quarter 2010 SIFMA Government Forecast Survey

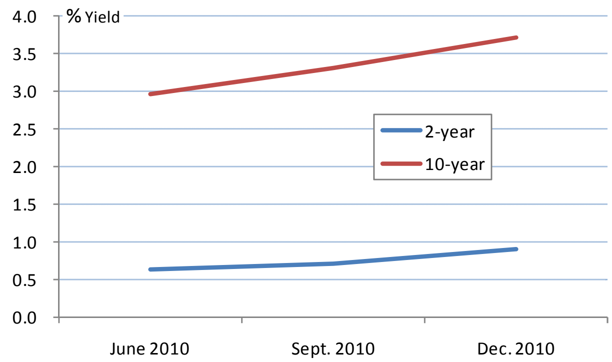
[5] Includes Fannie Mae, Freddie Mac, the Federal Home Loan Banks (FHLBs), and the Federal Farm Credit Banks Funding Corporation.

[6] Net bill issuance projections for the third quarter of 2010 ranged from zero to $80 billion.

[7] As of July 26, the 2-year note yield was 0.56 percent, the 5-year note yield was 1.73 percent, the 10-year note yield was 2.99 percent, and the 30-year bond yield was 4.02 percent.

[8] SIFMA's 2Q'10 Issuance and Rates Forecast survey (completed on April 23, 2010) estimated the 2-year note yield to be 1.2 percent at the end of the second quarter, 2.7 percent for the 5-year note yield, 4.0 percent for the 10-year note yield, and 4.9 percent for the 30-year bond yield.

Table 3. Projected 2-Year and 10-Year Treasury Yields



Source: Third Quarter 2010 SIFMA Government Forecast Survey

Upside and Downside Risks to Rates

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 5). The dominant risks identified on the upside (higher-than-expected yields) were: greater-than-expected economic recovery/growth; more stable European debt environment; and inflation. The main risks noted on the downside (lower-than-expected yields) were: lower-than-expected economic growth; reignited European sovereign debt concerns; deflation; and a double-dip.

Table 5. Summary of Risks to Rate Forecasts

	Risks to Upside	Risks to Downside
#1	Strong growth and market not digesting supply	Double dip; Europe
#2	Increased concern about budget deficit. Stronger than expected economic recovery.	Weaker consumer spending. Asset values decline. Euro-sovereign issue flares again.
#3	Upside risks stem from improvement in inflation data.	Downside risks stem from a re-emergence of sovereign crisis in Euro and loss of credibility of European stress test results.
#4	Stable Europe	Continued disinflation
#5	The major upside risk to our interest rate forecast is higher than expected inflation.	The major downside risk to our interest rate forecast is lower than expected growth.
#6	Growth rebounds much faster than anticipated, putting the Fed back in play prior to the end of 2011.	Growth falls off a cliff, potentially leading to deflation and/or further asset purchases by the Fed.

Source: Third Quarter 2010 SIFMA Government Forecast Survey

Spreads Outlook

Respondents expect agency-to-Treasury yield spreads and swap-to-Treasury yield spreads to largely decrease in the third quarter of 2010, with the exception of the 2-year agencies spread, which is expected to rise 4 bps to 17 bps at the end of 3Q'10. The exact opposite is expected to occur in the last quarter of this year, with all spreads increasing except for the 2-year agencies spread.

The largest changes are expected to be the following: a 10 bps drop in 5-year agencies spread at end-3Q'10; 11 bps decline in 2-year swap spread at end-3Q'10, followed by a 10 bps jump at end-4Q'10; and 5 bps increases in the 10-year agencies spread, 5- and 10-year swap spreads at end-4Q'10 following their moderate decreases (1 to 2 bps) at end-3Q'10.

The 3-month LIBOR rate is expected to increase through the rest of the year, to 0.6 percent at end-3Q'10 and 0.7 percent at year-end.

Portfolio Allocation Recommendations

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 generally favor a neutral recommendation across all maturities, with the remaining responses almost equally divided between over- or under-weight (see Table 6).

Table 6. Distribution of Duration Weightings

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

Source: Third Quarter 2010 SIFMA Government Forecast Survey; percent of total respondees

SIFMA's Government Securities Issuance and Rates Forecast

Forecast numbers appear in bold

Issuance Projections

$ Billions

U.S. Treasury Borrowing[1]	2Q'10	3Q'10
Net Coupon Issuance	404.5	**376.0**
Gross Coupon Issuance	*601.6*	***531.0***
Gross Coupon Redemptions	*197.1*	***155.0***
Net Bill Issuance	(61.0)	**23.0**
Gross Bill Issuance	*1,576.7*	***1,390.0***
Gross Bill Redemptions	*1,637.7*	***1,310.0***
Quarter end cash balance (expected)	280.0	**272.5**
U.S. Treasury Quarterly Gross New Issuance		
4 week Bill	430.3	**435.0**
13 week Bill	342.0	**418.5**
26 week Bill	346.0	**418.5**
52 week Bill	77.0	**100.0**
2 year Treasury Note	129.0	**108.5**
3 year Treasury Note	120.5	**102.0**
5 year Treasury Note	122.9	**108.0**
7 year Treasury Note	95.2	**84.0**
10 year Treasury Note	69.8	**64.5**
30 year Treasury Bond	44.4	**41.0**
Treasury Inflation-Indexed Securities	19.8	**28.0**
Federal Agency: Projected Total Gross Coupon Debt Issuance[2]		
Fannie Mae	83.7	**82.0**
Freddie Mac	70.0	**90.0**
Federal Home Loan Bank System - Office of Finance	51.1	**130.0**
Federal Farm Credit Banks Funding Corporation	27.3	**25.0**

	FY estimates
Federal Budget Deficit Estimate - FY2010	**1,315.0**
Federal Budget Deficit Estimate - FY2011	**1,050.0**
Federal Budget Deficit Estimate - FY2012	**850.0**

Rates & Spreads Outlook

	6/30/10	9/30/10	12/31/10
Interest Rates (End of Quarter in %Yield)			
2 year Treasury Note	0.62	**0.7**	**0.9**
5 year Treasury Note	1.79	**2.0**	**2.3**
10 year Treasury Note	2.95	**3.3**	**3.7**
30 year Treasury Bond	3.91	**4.2**	**4.4**
3 Month LIBOR	0.53	**0.6**	**0.7**
Spreads to Treasury (End of Quarter in Basis Points)			
2 year Agency Benchmark/Reference Notes[3]	13.0	**17.0**	**15.0**
5 year Agency Benchmark/Reference Notes[3]	33.0	**23.0**	**25.0**
10 year Agency Benchmark/Reference Notes[3]	21.0	**20.0**	**25.0**
2 Year SWAP Spreads	35.8	**25.0**	**35.0**
5 Year SWAP Spreads	26.8	**25.0**	**30.0**
10 Year SWAP Spreads	6.7	**5.0**	**10.0**

[1] *Excluding Federal Reserve's purchase*

[2] *Including all callable coupon issuance and excluding all discount notes*

[3] *Agency spreads to Treasury yield are in basis points.*

U.S. GOVERNMENT FORECAST

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The Securities Industry and Financial Markets Association's Quarterly Government Securities Issuance and Rates Forecast reflects the responses to a survey of members of the Association's Primary Dealers Committee and Government Securities Research and Strategist 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.