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

T-Bill Issuance to Shrink More Than Coupon Issuance; Yield Curve to Flatten as Economic Uncertainty Lingers

Issuance Forecasts

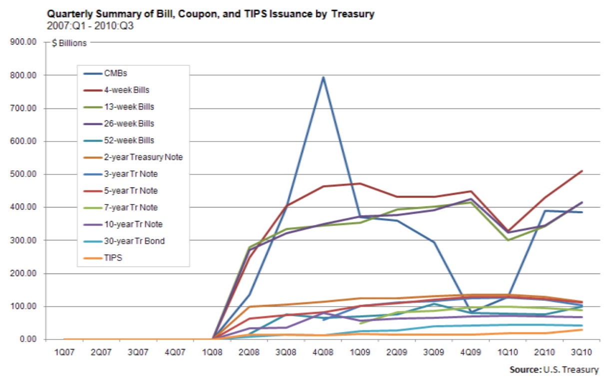
TOTAL ISSUANCE OUTLOOK The SIFMA Quarterly Issuance Survey[1] forecasts total net Treasury bill, note and bond issuance to be $387.0 billion in the fourth quarter of 2010, slightly under the net $395.8 billion issued ($399.0 billion previously forecast in SIFMA's 3Q'10 issuance survey[2]) in the third quarter (as a reminder, actuals include cash management balances).

Excluding the cash management bills (CMBs), total net issuance was $10.8 billion in the third quarter, compared to $(45.4) billion in 2Q'10. This jump was primarily the result of a significant increase in total issuance for the month of August (especially coupon issuance, which soared from $81 billion to $297.5 billion month over month, or m/m) plus lesser total redemptions (especially bill redemptions, which fell 21.5 percent m/m). The use of short-term CMBs has remained steady throughout the third quarter, and Treasury continues to attribute $200 billion to its Supplementary Financing Program (SFP). The total 3Q'10 net issuance of $395.8 billion was 13.1 percent higher than Treasury's August borrowing estimate of $350 billion for the third quarter. However, the $387.0 billion forecast for 4Q'10 net issuance by survey participants is roughly in-line with Treasury's August estimate of $380 billion for the fourth quarter.

Overall, the issuance of both shorter-term T-bills and longer-term coupons are expected to decline in 4Q'10. Notably, survey respondents forecast decreases in bill issuance to be relatively greater than decreases in issuance of notes and bonds, particularly in the case of 4-week bills. As the economic recovery continues to falter and market confidence erodes, the Federal Reserve has indicated it may implement a second stage of quantitative easing. In response, the marketplace has already largely priced in an approximate $500 billion to $1 trillion in such asset purchases.

With implementation of Dodd-Frank also well under way, regulators and industry participants alike are racing to address and meet deadlines for hundreds of studies and rulemakings, adding to overall market uncertainty and frenzy.

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 $364 billion in the fourth quarter, 6.6 percent below 3Q'10's net issuance of $389.9 billion but in-line with 4Q'09's $362.5 billion.[3] In addition, survey respondents expect Treasury to finish the year with $270 billion in cash (accounting for the $200 billion SFP limit)[4], which is directly in-line with the $270 billion Treasury estimated in August for both end-September and end-December 2010 cash balances.

The fourth quarter forecast for gross coupon issuance is $489 billion, nearly 8 percent below the $530.2 billion issued in the third quarter, and nearly 16 percent below the $581.8 billion issued in the second quarter this year. This further supports Treasury's previously announced intent to decrease the sizes of coupon auctions going forward[5].

The median forecast for gross combined coupon and TIPS issuance in the fourth quarter is $508.5 billion, an over 9 percent drop from 3Q'10's $559.5 billion and a 17 percent drop from 4Q'09's $613 billion

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[1] The survey was conducted beginning on October 6, 2010 and ending on October 25, 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 3Q'10 Government Forecast Survey results can be found here.

[3] Net coupon issuance projections for the fourth quarter of 2010 ranged from $356 billion to $373 billion.

[4] Net cash position projections for the end of the fourth quarter 2010 ranged from $225 billion to $300 billion.

[5] See US Treasury's August 2010 Quarterly Refunding Statement.

issued. Approximately 20 percent is expected to be in 2-year notes, 18 percent in 3-year notes, 20 percent in 5-year notes, 17 percent in 7-year notes, 13 percent in 10-year notes, 8 percent in 30-year bonds and the remaining 4 percent in TIPS.

AGENCIES' COUPON ISSUANCE Survey participants forecast total gross coupon issuance by the four largest Federal agencies to be $334.5 billion in the fourth quarter, compared to $250.7 billion in 3Q'10, a 33.4 percent increase.[6] Treasury continues to expect to release a report sometime in early 2011 outlining their proposals and recommendations for potentially bringing mortgage giants Fannie Mae and Freddie Mac out of conservatorship. No one obvious solution has emerged to date, and proposals range widely, from fully abolishing the two agencies to continuing their current operations, or creating a covered bond market in the U.S. or establishing some mortgage insurance fund.

Approximately 37 percent of 4Q'10's issuance volume is expected to come from the Federal Home Loan Banks (FHLBs), 32 percent from Fannie Mae, 24 percent from Freddie Mac, and the remaining 7 percent from the Farm Credit System Banks.

T-BILL ISSUANCE Survey respondents expect a net bill issuance of $23 billion in the fourth quarter, compared to a net issuance of $5.9 billion in 3Q'10 and a significant net redemption of $203 billion in 4Q'09. Responses received[7] varied quite widely (and interestingly, median forecasts for *both* gross issuance and gross redemptions are $1.32 trillion for the fourth quarter), further highlighting the uncertainty of the economy's direction looking forward and Treasury's related funding strategies.

The $1.32 trillion (or $1.13 trillion when individual median bill forecasts were summed) expected in gross issuance is markedly less than the $1.44 trillion of regular series bills issued in the third quarter, and nearly 28 percent below the $1.83 trillion of total bills (including CMBs) that were issued in 3Q'10.

TIPS Survey respondents forecast Treasury will issue $19.5 billion of Treasury Inflation-Protected Securities (TIPS) in 4Q'10, 33 percent *below* the $29.3 billion issued in 3Q'10. Treasury continues to consider additional reopenings in order to increase the frequency of TIPS auctions, as needed.

U.S. Treasury Yield Outlook

The survey forecasts benchmark Treasury yields will stay relatively flat or decrease going through the end of the year, even when compared to levels prevalent at the time the survey was compiled.[8] Not surprisingly, yields have dropped significantly through this past quarter[9]. Economic conditions remain questionable, labor statistics are faltering, housing markets continue to see problems related to sales and foreclosures, and there is growing strong consensus that the Federal Reserve will interject again with a second round of quantitative easing. Looking even further ahead to 1Q'11, survey participants forecast yields to continue to stay flat or continue their freefall.

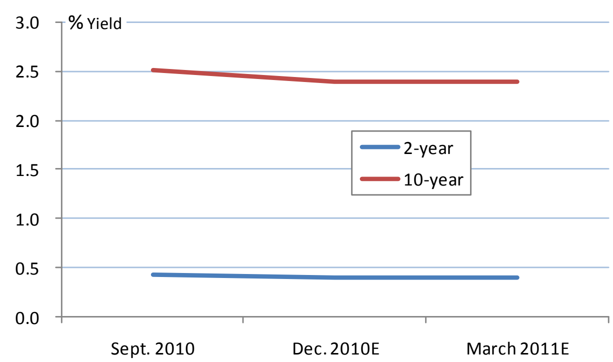
Table 2. Treasury Yield Projections and Ranges

	Sept. 30, 2010	Dec. 30, 2010E	March 31, 2011E
2 year Treasury Note	0.42	**0.4** (0.3 - 0.5)	**0.4** (0.3 - 0.6)
5 year Treasury Note	1.28	**1.2** (0.8 - 1.4)	**1.2** (0.8 - 2.0)
10 year Treasury Note	2.52	**2.4** (2.0 - 2.9)	**2.4** (2.0 - 3.7)
30 year Treasury Bond	3.69	**3.7** (3.3 - 4.2)	**3.6** (3.3 - 4.8)
3 Month LIBOR	0.29	**0.3**	**0.4**

Source: Fourth Quarter 2010 SIFMA Government Forecast Survey

As a result, the yield curve is expected to largely flatten going through the next two quarters.

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



Source: Fourth 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 4). The dominant risks identified on the upside (higher-than-expected yields) were: stronger-than-expected economic recovery/growth;

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

[7] Net bill issuance projections for the fourth quarter of 2010 ranged from a net redemption of $32 billion to a net issuance of $100 billion.

[8] As of October 25, the 2-year note yield was 0.36 percent, the 5-year note yield was 1.17 percent, the 10-year note yield was 2.55 percent, and the 30-year bond yield was 3.91 percent.

[9] As of June 30, 2010, the 2-year note yield was 0.62 percent, 5-year note was 1.79 percent, 10-year note was 2.95 percent, and 30-year bond was 3.91 percent. SIFMA's 3Q'10 Issuance and Rates Forecast survey (completed on July 29, 2010) actually estimated the 2-year note yield to be 0.7 percent at the end of the 3Q'10, 2.0 percent for the 5-year note yield, 3.3 percent for the 10-year note yield, and 4.2 percent for the 30-year bond yield.

inflation; and weaker-than-expected quantitative easing by the Fed. Conversely, the main risks noted on the downside (lower-than-expected yields) were: weaker-than-expected economic growth; worsening unemployment; deflation; and greater-than-expected easing efforts.

Table 4. Summary of Risks to Rate Forecasts

	Risks to Upside	Risks to Downside
#1	Yields rise as pace and size of expected QE operation falls short.	Disinflation leads to deflation; savings rate rises; job market deteriorates.
#2	Weak QE, stronger economy, yuan revaluation	Strong QE
#3	Inflation expectations increase dramatically.	Upcoming Fed QE announcement is larger than expected or if growth numbers are significantly weaker than expected.
#4	Mainly improvement in jobless data and higher inflation speculated through more quantitative easing policies, especially in the long-end.	Disappointment in jobless data and larger than expected QE purchase for short to intermediate sectors.
#5	Higher than expected inflation and related rise in inflation risk premium may lead to higher rates.	Weaker than expected economic data may lead to additional quantitative easing being priced in by the market.
#6	If the QE is less than expected, the Treasury market will sell off dramatically. We think that the market is expected at least $500 billion of asset purchases in Treasury securities in addition to either a price target or hardened language by the Fed.	If the Fed changes the SOMA limit in the next meeting, it will imply that the asset purchases will be much larger than expected. The major upcoming risks have to do with the Fed meeting and election next week.
#7	Fed disappoints the market with regards to expectations for additional asset purchases.	Larger than anticipated purchase expansion

Source: Fourth Quarter 2010 SIFMA Government Forecast Survey

Spreads Outlook

Respondents expect agency-to-Treasury yield spreads and swap-to-Treasury yield spreads to largely increase through the next two consecutive quarters, with the exception of the 5-year agencies spread, which is however expected to rise in 2011. The greatest increases are projected to be in the 10-year agencies spread and the 10-year swap spread, both by year end.

The 3-month LIBOR rate is expected to rise slightly as well through the next two consecutive quarters, to 0.3 percent at year-end and 0.4 percent by end-1Q'11.

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 an overwhelmingly neutral recommendation for 0-3 years duration, with a tendency towards over weightings for 3-10 years duration, and mixed feelings toward the 10-30 years range (2 participants were strongly underweight here, yet 3 respondents were also overweight). Notably, none were strongly underweight for anything less than 10 years duration.

Table 5. Distribution of Duration Weightings

	Strong Over	Over	Neutral	Under	Strong Under
0-3 yrs	0%	0%	88%	13%	0%
3-7 yrs	13%	38%	25%	25%	0%
7-10 yrs	38%	50%	0%	13%	0%
10-30 yrs	0%	38%	25%	13%	25%

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

U.S. GOVERNMENT FORECAST

SIFMA's Government Securities Issuance and Rates Forecast

Forecast numbers appear in bold

Issuance Projections

$ Billions

U.S. Treasury Borrowing[1]	3Q'10	4Q'10E
Net Coupon Issuance	389.9	**364.0**
Gross Coupon Issuance	*559.5*	***507.0***
Gross Coupon Redemptions	*169.6*	***142.0***
Net Bill Issuance	5.9	**23.0**
Gross Bill Issuance	*1,826.0*	***1,319.5***
Gross Bill Redemptions	*1,820.1*	***1,319.0***
Quarter end cash balance (expected)	270.0	**270.0**
U.S. Treasury Quarterly Gross New Issuance		
4 week Bill	511.0	**325.0**
13 week Bill	415.0	**372.0**
26 week Bill	415.0	**361.0**
52 week Bill	100.0	**72.0**
2 year Treasury Note	114.3	**102.0**
3 year Treasury Note	104.4	**93.0**
5 year Treasury Note	111.2	**99.0**
7 year Treasury Note	89.6	**87.0**
10 year Treasury Note	67.7	**66.0**
30 year Treasury Bond	43.1	**42.0**
Treasury Inflation-Indexed Securities	29.3	**19.5**
Federal Agency: Projected Total Gross Coupon Debt Issuance[2]		
Fannie Mae	114.1	**107.0**
Freddie Mac	47.9	**80.0**
Federal Home Loan Bank System - Office of Finance	66.2	**122.5**
Federal Farm Credit Banks Funding Corporation	22.5	**25.0**

	FY estimates
Federal Budget Deficit Estimate - FY2010	**1,269.5**
Federal Budget Deficit Estimate - FY2011	**1,100.0**
Federal Budget Deficit Estimate - FY2012	**914.0**

Rates & Spreads Outlook

	9/30/10	12/31/10E	3/31/11E
Interest Rates (End of Quarter in %Yield)			
2 year Treasury Note	0.42	**0.4**	**0.4**
5 year Treasury Note	1.28	**1.2**	**1.2**
10 year Treasury Note	2.52	**2.4**	**2.4**
30 year Treasury Bond	3.69	**3.7**	**3.6**
3 Month LIBOR	0.29	**0.3**	**0.4**
Spreads to Treasury (End of Quarter in Basis Points)			
2 year Agency Benchmark/Reference Notes[3]	8.5	**11.0**	**12.5**
5 year Agency Benchmark/Reference Notes[3]	32.0	**25.0**	**30.0**
10 year Agency Benchmark/Reference Notes[3]	10.5	**35.0**	**40.0**
2 Year SWAP Spreads	17.7	**20.0**	**23.5**
5 Year SWAP Spreads	23.5	**30.0**	**35.0**
10 Year SWAP Spreads	5.5	**15.0**	**20.0**

[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.*

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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.