# Research
## Government Forecast

SIFMA
Securities Industry and Financial Markets Association

The Securities Industry and Financial Markets Association[1] (SIFMA) 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.

October 2008

**Contributors**

**Robert Toomey**
Staff Advisor
Government Securities Research, Analysis and Strategy Committee

**Tiffany Coln**
Director, Research

## Fourth Quarter Total Net Issuance Expected to Rise on Larger Budget Deficit Projection

The median survey response forecast total net Treasury bill, note and bond issuance to be $388.0 billion in the fourth quarter of 2008, higher than the $178.4 billion issued in the third quarter and the $33.4 billion issued in the fourth quarter a year ago[3]. The year-over-year projected increase is consistent with the higher budget deficit forecast for this fiscal year. The quarter-over-quarter projected increase in issuance volumes includes the effect of the recently passed *Emergency Economic Stabilization Act* (EESA) of 2008. The gross Treasury issuance forecast, which is forecasted to be lower than that in the third 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 $129.0 billion for the fourth quarter. This represents a 14.0 percent decline in net new issuance volume from the $150.1 billion issued in the third quarter of 2008 and a greater than three-fold increase from the $41.0 billion in the fourth quarter a year ago[4]. Based on the median forecast, the committee believes the Treasury Department will finish the quarter with a cash position of $245 billion, 34.1 percent below the balance of $371.6 billion at the end of the third quarter of 2008, but substantially higher than the $57.0 billion balance a year ago[5].

The median forecast for gross nominal coupon issuance is $228.0 billion for the fourth quarter, a decline from the $230.1 billion in the previous quarter, and lower than the $157.3 billion in the fourth quarter a year ago. According to the survey, Treasury will issue $12.0 billion of Treasury Inflation-Protected Securities (TIPS) in the fourth quarter of 2008, slightly lower than the $14.0 billion issued in the previous quarter, but the same as in the fourth quarter of 2007.

The median forecast for gross combined coupon and TIPS issuance in the fourth quarter is $240.0 billion, compared to $244.1 billion in the third quarter and $169.3 billion in the fourth quarter of 2008. Of the $240.0 billion is-

New York
Washington
London
Hong Kong

www.sifma.org



[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 3, 2008, subsequent to the announcement of the September monthly employment data. The Committee received responses from 6 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 year unless otherwise noted.

[4] Net coupon issuance projections for the fourth quarter of 2008 ranged from $73 billion to $913 billion.

[5] Net cash position projections for the end of the fourth quarter 2008 ranged from $25 billion to $1,956 billion.

suance projected, approximately 46 percent will be 2-year nominal notes, 32 percent 5-year nominal notes, 13 percent 10-year nominal notes, 4 percent 30-year bonds and 5 percent TIPS.

### Bill Issuance

The survey projects net bill issuance of $259.0 billion for the fourth calendar quarter of this year, compared to a net issuance of $28.3 billion in the third quarter and $7.2 billion net paydown in the fourth quarter of last year[6]. The sharply higher net issuance projection incorporates the effect of higher demand for cash as the Treasury acts to stabilize the economy and adds liquidity to the credit markets. Gross bill issuance is expected to total $1,032.0 billion for the fourth quarter, less than the $1,136.4 billion in the third quarter, but higher than the $907.3 billion in the fourth quarter last year. The gross bill issuance projection relative to net bill issuance suggests that the volume of bills maturing will be below that in the third quarter of this year and the fourth quarter a year ago.

Combining net coupon and net bill forecasts, the median expectation is total net Treasury securities issuance of roughly $388.0 billion in the fourth quarter, compared to a net issuance of $178.4 billion last quarter and net issuance of $33.8 billion during the fourth quarter of 2007.

### Budget Deficit Projection

The survey results project a federal budget deficit of $687.5 billion for FY 09, higher than the record deficit of $455 billion in FY 08. The higher deficit projection may reflect expectations of moderating tax revenue growth due to the prolonged economic downturn and the continuing need to correct credit market disruptions and add confidence to the financial markets. Over its history, this survey's median projected deficit forecasts have tended to be relative conservative, i.e. higher than actual.

The FY 08 budget deficit came in higher than expected due to lower revenues and increased expenditures related to the troubled economy and higher defense spending. The tax revenue and expenditure growth rate had been moderating in the last few years. Fiscal year 2008 combined corporate and individual income tax receipts are running about 5 percent below last year's levels, with corporate tax receipts 17.8 percent lower and individual tax receipts 1.5 percent lower. Total government revenues are 1.7 percent behind last year's pace for the fiscal year, while expenditures are 9.1 percent higher.

### U.S. Treasury Yield Outlook: Yields Down, Curve Steeper

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 and 10-year yield to fall below the current levels[7]. Benchmark yields are expected to fall by the end of the fourth quarter, and remain below the current level at the end of March 2009.

### Interest Rate and Yield Curve Forecast

The median forecast is for a 10-year Treasury yield of 3.60 percent at the end of the fourth quarter and 3.73 percent at the end of the first quarter of 2009. The median forecast projects the 30-year bond yield to be 4.23 percent at the end of the fourth quarter and 4.40 percent at the end of the first quarter next year. The 2-year Treasury will yield 1.30 percent at the end of the year and 1.15 percent at the end of next March, according to the survey[8]. The 2-year Treasury yield forecast appears to suggest that the Federal Open Market Committee (FOMC) is likely to cut rates further due to the current credit market stress and need to add liquidity to the market.

In addition, the survey results project a steepening of the yield curve over the next few quarters as measured by the 2-year to 10-year Treasury yield spread. Over the past few months, there had been a slight steepening of the yield curve, with the 2-year to 10-year Treasury yield spread widening to 224 basis points in early October from 186 basis points at the end of the third quarter. Based on the median projection, the 2-year to 10-year Treasury yield spread will be 230 basis points at the end of the fourth quarter and is forecast to be 258 basis points at the end of the first quarter of 2009.

### Faster Recovery to Economy Yields Upside Risk, Continued Worsening in the Financial Markets and Deep Recession are Downside Risks

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 identified on the upside was a faster-than-expected recovery. Conversely, the dominant downside risks to the forecast identified were a further worsening of conditions in the financial markets resulting from deterioration in interbank lending and a continued intensifying of the credit crunch. A deep recession and possible depression, and further easing by the Fed can continue to push yields lower.

*[6] Net bill issuance projections for the third quarter ranged from $54 billion to $2,393 billion. A negative net issuance number may be interpreted as a net paydown of outstanding Treasury debt.*

*[7] The 2-year note yield was 1.63 percent and 10-year yield was 3.87 percent at the end of the survey period, October 10*

*[8] Projections for the end-fourth quarter 2008 10-year Treasury yield ranged from 3.35 percent to 4.00 percent and for the 2-year Treasury yield ranged from 1.00 percent to 1.60 percent*

### Federal Agency Issuance to be Lower

The survey forecasts total gross note issuance by the four largest Federal agencies of $195.0 billion in the fourth quarter, compared to $198.8 billion in the third quarter[9]. Slightly less not more than a two-thirds of the issuance volume is expected to come from the Federal Home Loan Banks (FHLBs), reflecting their continued importance as a 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 the lack of credit available and continued weakness in the housing market. The relatively modest magnitude of the decline reflects agency financing cost advantage relative to non-agency mortgage-backed securities (MBS) and expanded mortgage purchasing authority, including the temporary increase in the conforming loan limit.

### Agency-to-Treasury Spreads Expected to Tighten

The panelists expect agency spreads to continue to tighten over the next few quarters across the maturity spectrum. The tighter agency spread outlook may indicate an implicit view of improved credit market conditions later in the year. At the end of the survey period, 3-month LIBOR stood at 4.05 percent. The median projection for 3-month LIBOR is a marked decline from the 4.05 percent at the end of the survey period to 3.20 at the end of the year. Like Treasury yields, 3-month LIBOR is expected to continue to decline into the new year, to 2.83 percent at the end of the first quarter next year.

### Survey Respondents Recommend Intermediate Portfolio Durations

The survey asked 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 consensus shows a slight preference for intermediate durations. The net underweight in all categories may suggest a stabilization of the credit markets for the balance of the year.

Approximately 60 percent of the survey respondents favored an overweight position in the 0- to 3-year sector, while the remaining 40 percent recommend being neutral. For the intermediate duration, the 3- to 7-year sector, 60 percent recommended overweighting with the remaining 40 percent recommending underweighting. In the 7- to 10-year sector, 40 percent recommend overweighting, with 40 percent recommending underweighting the category. In contrast to the short-duration sector, 40 percent recommended underweighting and the balance recommending neutrality.

[9] *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:Q3 | 2008:Q4 |
| **U.S. Treasury Borrowing**[1] | | |
| Net Coupon Issuance | 150 | **129** |
| Net Bill Issuance | 28 | **259** |
| Quarter end cash balance | 372 | **245** |
| **U.S. Treasury Quarterly Gross New Issuance** | | |
| 4 week Bill | 404 | **305** |
| 13 week Bill | 337 | **338** |
| 26 week Bill | 327 | **329** |
| 52 week Bill | 76 | **60** |
| 2 year Treasury Note | 106 | **111** |
| 5 year Treasury Note | 73 | **77** |
| 10 year Treasury Note | 37 | **32** |
| 30 year Treasury Bond | 14 | **9** |
| Treasury Inflation-Protected Securities | 14 | **12** |
| **Federal Agency: Projected Total Gross Coupon Debt Issuance**[2] | | |
| Fannie Mae | 49 | **30** |
| Freddie Mac | 26 | **30** |
| Federal Home Loan Bank System - Office of Finance | 108 | **120** |
| Federal Farm Credit Banks Funding Corporation | 18 | **15** |
| Federal Budget Deficit Estimate - FY | 455 (FY08) | **688 (FY09)** |

| Rates & Spreads Outlook | Sept. 2008 | % Yields Dec. 2008 | Mar. 2009 |
|---|---|---|---|
| **Interest Rates (End of Quarter in % Yield)** | | | |
| 2 Year Treasury Note | 1.96 | **1.30** | **1.15** |
| 5 Year Treasury Note | 2.98 | **2.55** | **2.60** |
| 10 Year Treasury Note | 3.82 | **3.60** | **3.73** |
| 30 Year Treasury Bond | 4.31 | **4.23** | **4.40** |
| 3 Month LIBOR | 4.05 | **3.20** | **2.83** |
| 2 Year Agency Benchmark/Reference Notes[3] | 106 | **110** | **75** |
| 5 Year Agency Benchmark/Reference Notes[3] | 95 | **100** | **65** |
| 10 Year Agency Benchmark/Reference Notes[3] | 84 | **90** | **70** |
| 2 Year SWAP Spreads | 140 | **120** | **98** |
| 5 Year SWAP Spreads | 100 | **100** | **78** |
| 10 Year SWAP Spreads | 55 | **60** | **53** |

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