

Research

Government Forecast



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The Bond Market Association¹ is today releasing its Quarterly Government Securities Issuance and Rates Forecast. The forecast reflects the results of a survey² of members of the Association's Government Securities Research Committee (Committee). The Committee is composed of trading strategists and research analysts at Association member firms who specialize and have expertise in the U.S. government securities, LIBOR swaps and federal agency securities markets. The Bond Market Association introduced the survey earlier this year. It was developed in order to provide market participants with the unique perspective available through current consensus expectations and median predictions of many of the dealers active in the U.S. government and agency securities markets.

Higher U.S. Treasury Issuance Volumes, Federal Budget Deficit

The Committee projects a federal budget deficit for fiscal year 2003 of \$400 billion, a 153 percent increase over the FY 2002 deficit of \$158 billion. This median projection reflects anticipated changes in spending and tax policy that affect near-term budget projections during the current fiscal year, including the recently enacted *Jobs and Growth Tax Relief and Reconciliation Act*.

As a result of the rising budget deficit, U.S. Treasury debt sales are expected to increase in the current quarter. The Committee's median forecast is \$89 billion of net new issuance of Treasury notes or "coupon" securities in the current quarter. This represents a 19 percent increase over net

note issuance in the second quarter of 2003 and a 134 percent increase over the third quarter of 2002. Based on the median forecast, the Committee believes the Treasury Department will finish the quarter with a cash balance of \$45 billion, compared to a balance of \$49 billion at the end of the second quarter.

Committee members were also asked to forecast gross issuance of U.S. Treasury notes for the third quarter of 2003. Based on the median survey response, coupon issuance is expected to total \$164 billion this quarter, 15 percent higher than the total for the second quarter of 2003 but 15 percent lower than the third quarter of 2002.

U.S. Treasury Yield Outlook: Rising Rates Later in the Year, Slightly Flatter Yield Curve

In addition, the Committee is issuing its consensus forecasts for the direction of benchmark interest rates. The Committee is calling for Treasury yields to rise and the Treasury yield curve to flatten modestly over the second half of the year compared to rates during the survey period. Both those trends are consistent with modest economic growth and expanding net issuance. During the survey period and just prior to the FOMC meeting on June 24-25, the ten-year Treasury note yielded 3.25

percent. (Subsequent to the FOMC meeting, the yield rose some 26 basis points to 3.51 percent as of the end of the second quarter, June 30.) The two-year yield during the survey period, just prior to the FOMC meeting, was 1.10 percent. (At the end of the second quarter, June 30, subsequent to the FOMC announcement, the yield had reached 1.28 percent.) The median forecast is for the ten-year Treasury yield of 3.30 percent by the end of September and 3.50 percent by the end of the year. The

¹ The Association represents securities firms and banks that underwrite, distribute, and trade in fixed income securities, both domestically and internationally.

² The survey was conducted the week of June 23, 2003. The Committee received responses from 14 of its 17 members. The Committee conducts this survey on a quarterly basis.

median forecast for the two-year Treasury yield is 1.25 percent by the end of September and 1.43 percent by the end of the year.

In addition to rising rates, the forecasted yields indicate a modest “flattening” of the yield curve by the end of the year. During the survey period prior to the FOMC announcement, the spread between the yields on the two-year and ten-year Treasury notes was 215 basis points (2.15 percentage points), and 223 basis points at June 30. The median forecast calls for a 205 basis point spread between 2-year and 10-year yields by the end of September and 207 basis points by the end of the year.

Outlook For New Issuance by the Federal Agencies

The median survey forecast predicts total gross note issuance by the four largest Federal agencies³ to total \$280 billion in the third quarter.⁴ In recent years, callable debt and other products with option-like characteristics have been increasingly prominent in the funding strategy at the Federal agencies. That trend has continued year-to-date. Consequently, gross issuance by the agencies has become more sensitive to changes in interest rates.

Agency Spreads to Remain at Current Levels

The survey respondents’ prevailing view is that agency spreads will remain approximately unchanged from the end of the second quarter. Similarly, projections for the so-called “swap spreads”—the spread between Treasury yields and LIBOR-based swaps—indicate that these spreads will remain near current levels.

Longer Duration Portfolios Recommended

The Committee was also asked about 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 view was that investors should move towards a stronger weighting in longer

duration U.S. Treasuries. This “overweighting” recommendation was most pronounced in the longest duration classes of securities. The majority of Committee members responding to the survey believes investors should overweight their holdings of Treasuries with maturities longer than seven years. For short-dated Treasuries with maturities of three years or less, the Committee was split, with a slight bias towards underweighting securities in this category. These responses are generally consistent with an expectation for some flattening of the Treasury yield curve.

The members of The Bond Market Association’s Government Securities Research Committee consists of individuals from the following firms:

ABN AMRO Bank

Barclays Capital Inc.

Bear, Stearns & Co. Inc.

CitiGroup Global Markets Inc.

Credit Suisse First Boston LLC.

Deutsche Bank Securities Inc.

First Tennessee Capital Markets

Goldman, Sachs & Co.

HSBC Securities (USA) Inc.

J.P. Morgan Securities, Inc.

Lehman Brothers Inc.

Merrill Lynch Government Securities Inc.

Mizuho Securities USA Inc.

Morgan Stanley & Co. Incorporated

Nomura Securities International, Inc.

RBS Greenwich Capital

UBS Warburg LLC.

Michael Decker, Staff Advisor

Eric L. Foster, Staff Advisor

³ Includes Fannie Mae, Freddie Mac, the Federal Home Loan Banks and the Federal Farm Credit Banks Funding Corporation.

⁴ As of the date of this report, second quarter agency issuance data were not available.

The Bond Market Association Government Securities Research Committee Forecast

Forecast numbers appear in bold

ISSUANCE PROJECTIONS	2003:Q2	\$ BILLIONS	2003:Q3
U.S. Treasury Borrowing¹			
Net Coupon Issuance	75		89
Net Bill Issuance ²	-27		57
Quarter end cash balance	49		45
U.S. Treasury Quarterly Gross New Issuance			
4 week Bill	228		260
13 week Bill	277		229
26 week Bill	290		233
2 year Treasury Note	84		75
3 year Treasury Note	22		22
5 year Treasury Note	18		36
10 year Treasury Note	18		31
Federal Agency: Projected Total Gross Coupon Debt Issuance³			
Fannie Mae	NA		75
Freddie Mac	NA		65
Federal Home Loan Bank System – Office of Finance	NA		130

RATES & SPREADS OUTLOOK	JUNE 2003*	% YIELDS	SEPTEMBER 2003	DECEMBER 2003
Interest Rates (End of Quarter in % Yield)				
2 Year Treasury Note	1.10	1.25		1.43
5 Year Treasury Note	2.14	2.27		2.45
10 Year Treasury Note	3.25	3.30		3.50
30 Year Treasury Bond	4.34	4.40		4.50
2 Year Agency Benchmark/Reference Notes ⁴	10	10		12
5 Year Agency Benchmark/Reference Notes ⁴	23	22		22
10 Year Agency Benchmark/Reference Notes ⁴	33	36		34
3 Month LIBOR	1.01	0.99		1.00
2 Year Swap Spreads	17	19		20
5 Year Swap Spreads	28	30		30
10 Year Swap Spreads	31	31		33

¹Excluding Federal Reserve's Purchases.

²Excluding cash management bills – 2003 second quarter numbers not available at publishing time.

³Excluding all callable coupon issuance and excluding all discount notes.

⁴Indicate Agency spreads to constant maturity Treasury Yield Curve in basis points.

* As of June 24, 2003.