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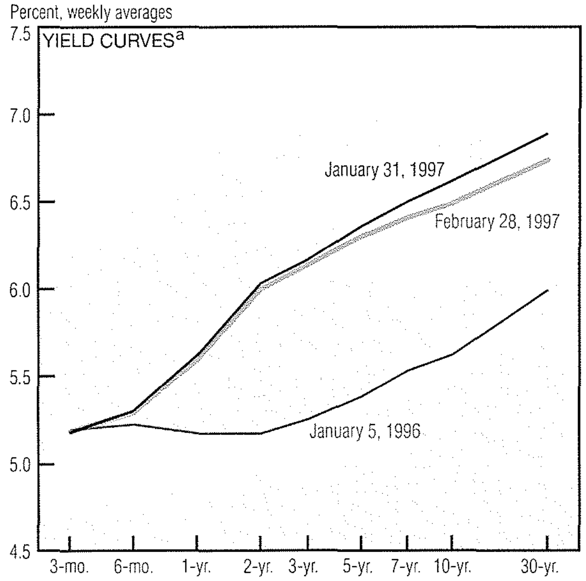
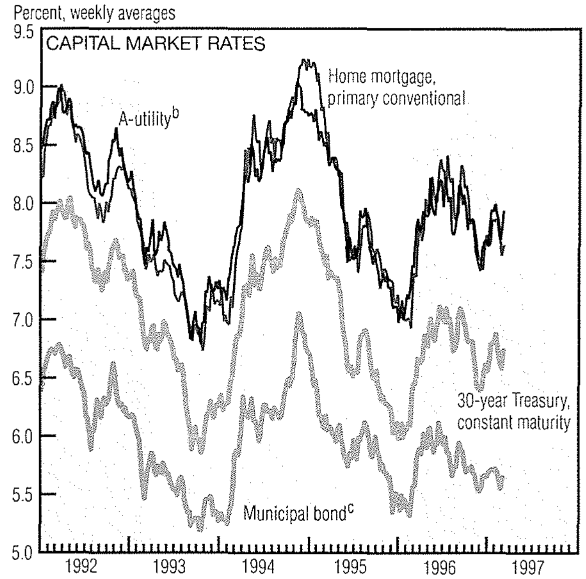
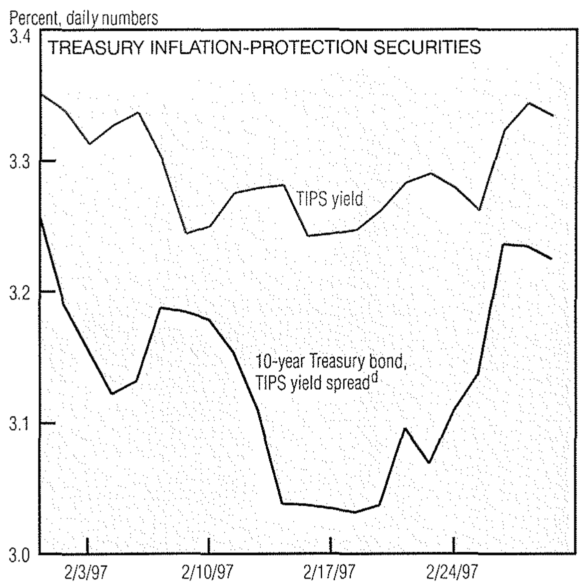
Interest Rates







Corporate Issues of Inflation-Indexed Bonds

J.P. Morgan & Company

Salomon Incorporated

Toyota Motor Credit Corporation

Tennessee Valley Authority

Federal Home Loan Bank System

Student Loan Marketing Association

Federal Farm Credit Banks & Funding Corporation

a. All instruments are constant-maturity series.
b. Estimate of the yield on a recently offered, A-rated utility bond with a maturity of 30 years and call protection of five years.
c. Bond Buyer Index, general obligation, 20 years to maturity, mixed quality.
d. 10-year Treasury bond constant-maturity yield minus the yield quote for the Treasury Inflation-Protection Securities found in Bloomberg information service.
SOURCES: Board of Governors of the Federal Reserve System; Bloomberg information service; and *The Wall Street Journal*, various issues.

Since last month, the yield curve has flattened slightly, with very little movement except at the long end. The 3-year, 3-month spread stands at 96 basis points (b.p.), and the 10-year, 3-month spread is at 131 b.p., both above their long-term mean. Since the beginning of last year, however, the curve has become noticeably steeper. At the long end, 30-year rates have risen nearly a point, while at the short end, the 2-year, 3-month spread has changed from a slight inversion of -2 b.p. to a more normal +82. The longer-term capital market rates continue to track changes in the 30-year Treasury bond closely.

Certainly the most exciting recent development in the bond market has been the introduction of Treasury Inflation-Protection Securities, or TIPS. The principal and coupon payments on these 10-year bonds rise (or fall) with changes in the Consumer Price Index. Besides potentially offering lower borrowing costs to the Treasury and long-term inflation protection to investors, TIPS are particularly intriguing because they may provide a direct measure of real interest rates and a better estimate of expected inflation.

Putting aside liquidity differences, the interaction between inflation and real interest rates, and the risk premium associated with inflation uncertainty, one can get a measure of expected inflation by subtracting the real interest rate observed from TIPS from the nominal 10-year rate on Treasury bonds. In terms of protecting investors, one desired result of the introduction of TIPS has already occurred—the private sector has begun to issue inflation-indexed bonds.