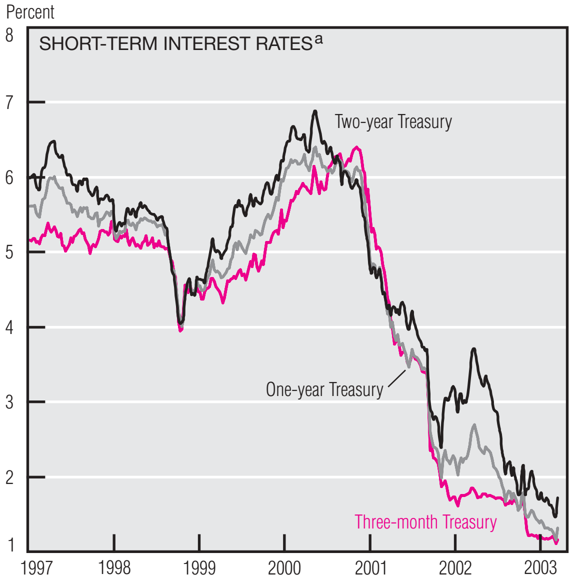
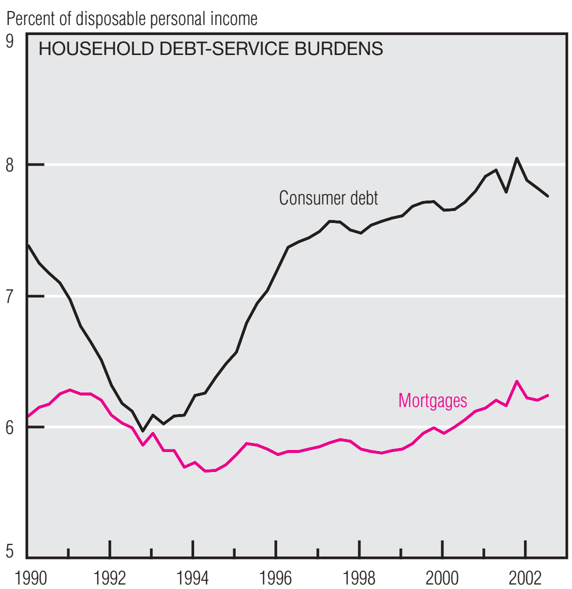
Money and Financial Markets





a. Constant maturity.
b. Merrill Lynch AA, BBB, and High Yield Master II indexes, each minus the yield on the 10-year Treasury note.
SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," H.15 and "Household Debt-Service Burden," *Federal Reserve Statistical Releases*; and Bloomberg Financial Information Services.

The yield curve's upward slope suggests that liquidity is adequate for economic expansion. Moreover, the recent increase in the curve's steepness reverses a disconcerting trend. In light of the historically low levels of both long- and short-term interest rates at present, the slope of the yield curve is consistent with the Federal Open Market Committee's (FOMC) view that monetary policy is accommodative and sufficient to engender better conditions should uncertainty diminish in the near term.

The fall of long-term interest rates in recent years has been especially marked in the mortgage market. Rates' increasing attractiveness clearly was a key factor in the housing market's robustness. Lower rates allowed consumers to increase debt levels substantially with a somewhat muted effect on debt-service burdens—essentially loan payments relative to personal disposable income. More generally, low short-term rates enhanced the attractiveness of home equity loans, instruments that finance a broad class of expenditures.

On the corporate side, diminished yield spreads between assets of different risk classes indicate that financial conditions are improving. Premiums on relatively safe corporate bonds have drifted down after a transitory run-up in the second half of 2002. Interest rates on investment-grade bonds are quite low by historical standards.

The FOMC's belief that the monetary policy stance is accommodative also reflects its perspective on longer-term economic fundamentals.

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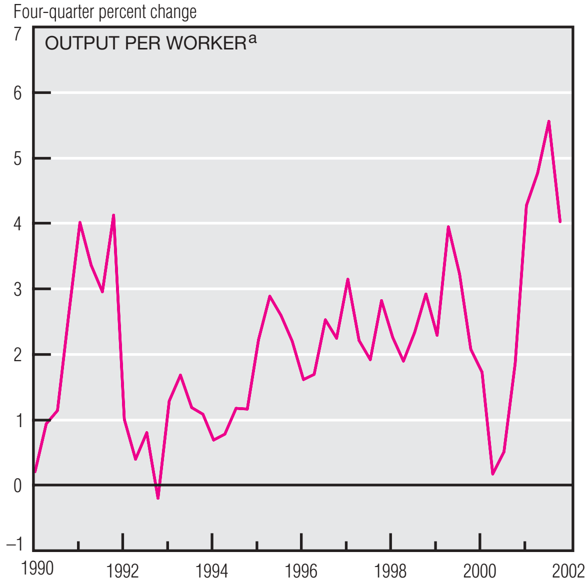

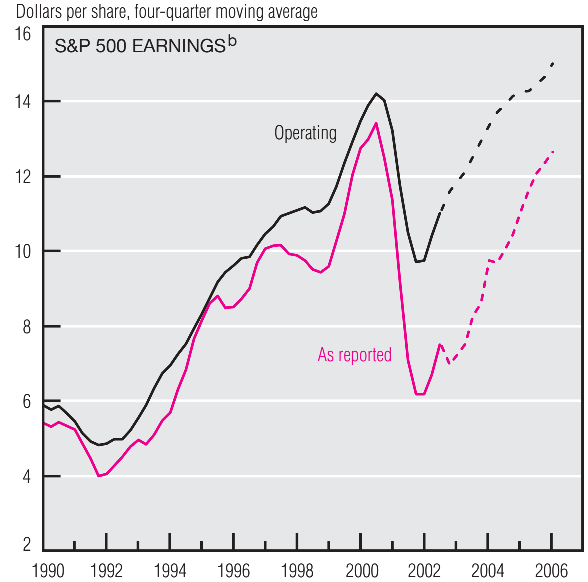

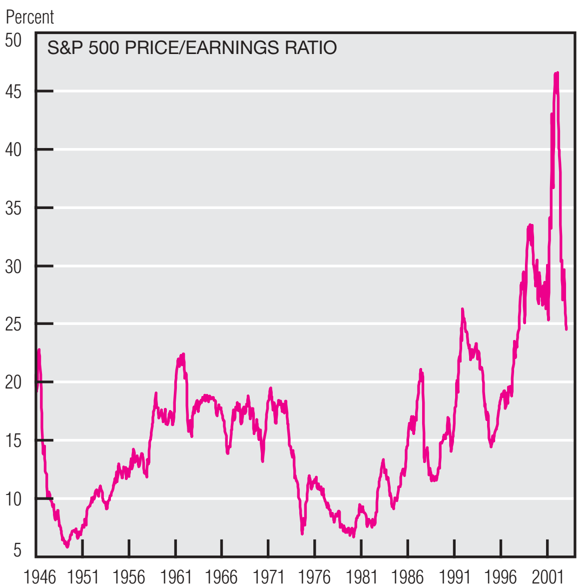

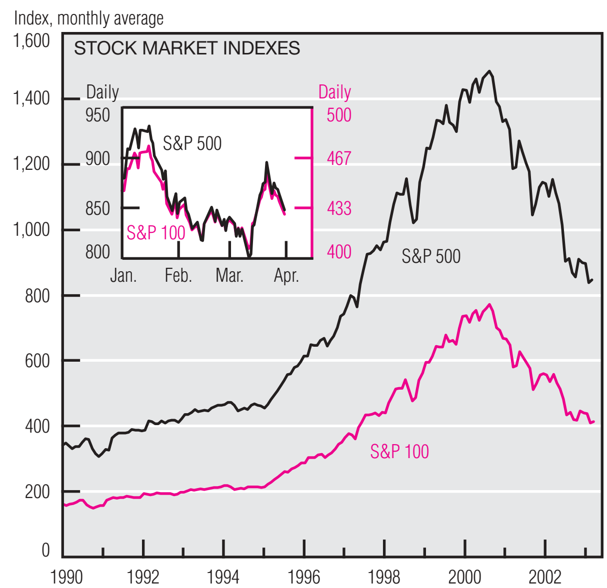

a. Nonfarm business sector.
b. The dashed lines show earnings estimates provided by Standard and Poor.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Standard and Poor Corporation; and Bloomberg Financial Information Services.

Productivity, which is key, accelerated in the mid-1990s, largely because of the growing use of information technology. Productivity growth has remained persistently high, notwithstanding a cyclical downturn in 2001. Prospects for continued benefits from adopting information technology—as revealed by analysts' projections for corporate earnings growth—suggest that rising levels of productivity growth could be sustained. Moreover, should higher earnings growth materialize, the recent decrease in the price/earnings ratio might accommodate a sustained turnaround in the stock market.

If not for the cloud of geopolitical uncertainty, favorable economic fundamentals would perhaps be evident in more rapid economic growth. Business plans that are now on hold would be implemented. Moreover, the FOMC characterizes the current state as a hesitancy of the economic expansion, conveying an implicit expectation that the uncertainty may be resolved quickly enough—that is, before the threat of an economic downturn materialized. Otherwise, additional rate cuts could be forthcoming. With federal funds futures suggesting that the odds of a modest cut are just even, and with eurodollar futures suggesting an upward trajectory later this year, the markets seem to share the FOMC's view.

Wide day-to-day variations in stock price indexes also suggest that a quick resolution to the Iraqi conflict would boost the economy. In the war's first days, optimistic expectations of a

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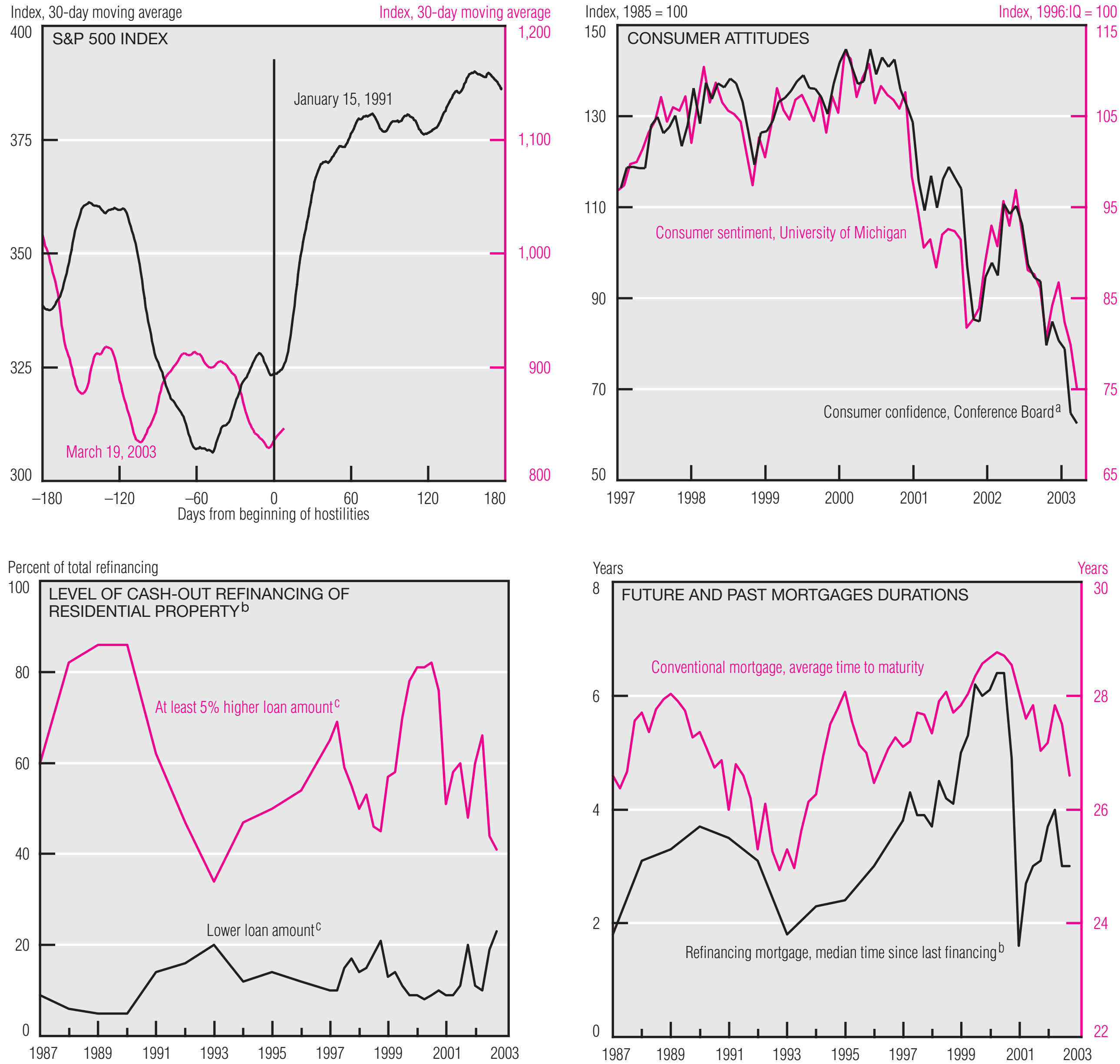

a. Data are seasonally adjusted.
b. Annual data until 1997.
c. Compared with previous financing.
SOURCES: Federal Housing Finance Board; Federal Home Loan Mortgage Corporation; Conference Board; University of Michigan; and Bloomberg Financial Information Services.

quick victory seemed to prevail, and the stock market rallied. As such hopes were dashed, however, much of the gain was retraced. In the six months after the 1990 Gulf War, equity markets rallied sharply, but it would be a mistake to generalize from one experience. An oft-cited 1989 research study suggests that there is no basis for reliably predicting how the market will behave after the present Iraqi war. That study shows that historically, the stock market's direction after "a major news event" does not differ significantly from the market's trend after any other day.

Although business spending dropped off in 2000 and remains guarded, consumers have proved to be resilient despite a sharp decline in consumer sentiment. Their resilience is largely owing to the drop in long-term interest rates, particularly in the mortgage market, where rates are near 40-year lows. Falling mortgage rates have helped sustain a housing boom. What may prove more important is that record-low rates allowed for a large volume of refinancings. Because refinancing rates have fallen so sharply, homeowners have been able to tap their home equity as a substantial source of funds. Indeed, many households increased loan amounts significantly yet reduced their monthly payments. The cash-out has been sufficient in some cases to purchase a car outright. Many analysts, however, consider this source of funds limited because interest rates cannot continue to fall forever.