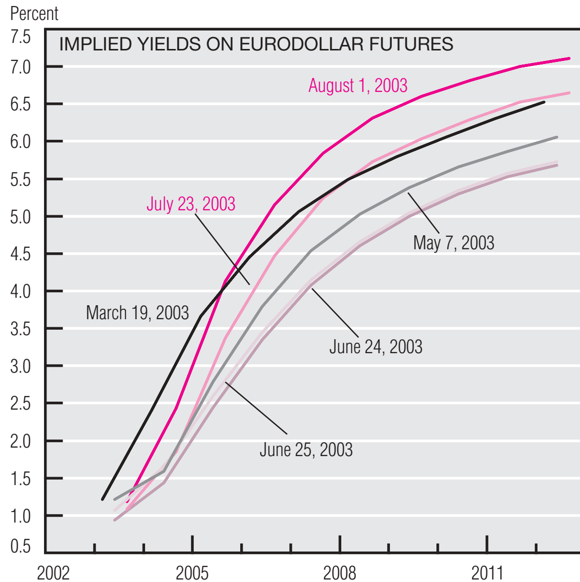
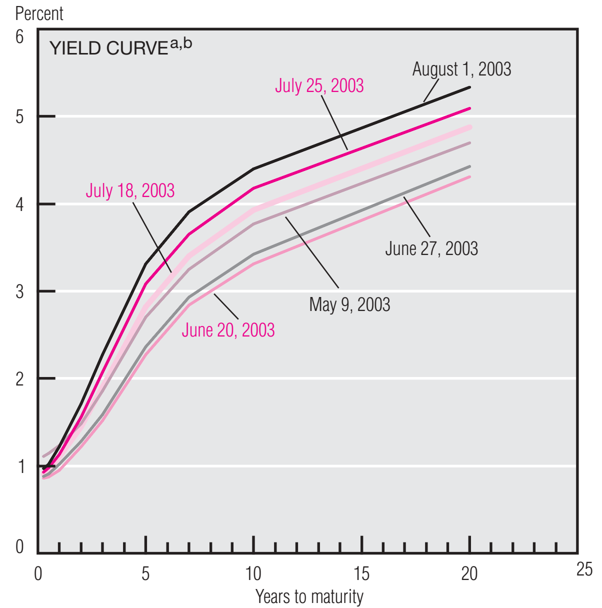
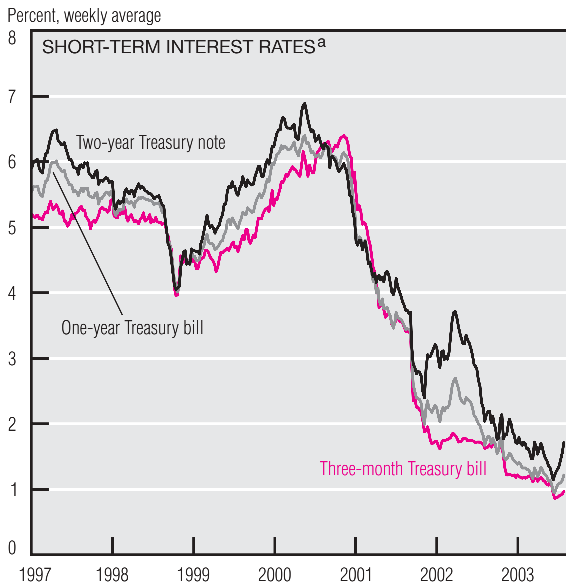
Money and Financial Markets







a. All yields are from constant-maturity series.
b. Average for the week ending on the date shown.
SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; and Bloomberg Financial Information Services.

The trajectory of expected future policy actions has changed dramatically since the beginning of summer. Although no policy actions appear imminent, federal funds futures suggest that rate hikes might begin early next year. Eurodollar futures, however, indicate that substantial rate hikes are not expected until 2005, keeping market interest rates below estimates of the longer-term equilibrium rate for at least a year. Implied yields on eurodollars remain persistently below the implied yields observed in March, which suggests that the policy stimulus will persist longer than was thought possible last spring.

Concerns about the prospect of deflation have largely abated. In his July 15 testimony before Congress, Federal Reserve Chairman Alan Greenspan reinforced this view by stating that, "…given the now highly stimulative stance of monetary and fiscal policy and well-anchored inflation expectations, the Committee concluded that economic fundamentals are such that situations requiring special policy actions are most unlikely to arise."

The belief that policy has become highly stimulative is consistent with recent changes in interest rates' term structure. The yield curve has steepened substantially since the last meeting of the Federal Open Market Committee. The yield on the one-year Treasury bill increased about 25 basis points (bp) from its recent low, while the yield on the 10-year Treasury bond jumped sharply by more than a percentage point.

Rates in private markets for long-term debt also rose markedly. Mortgage rates increased about 90 bp off

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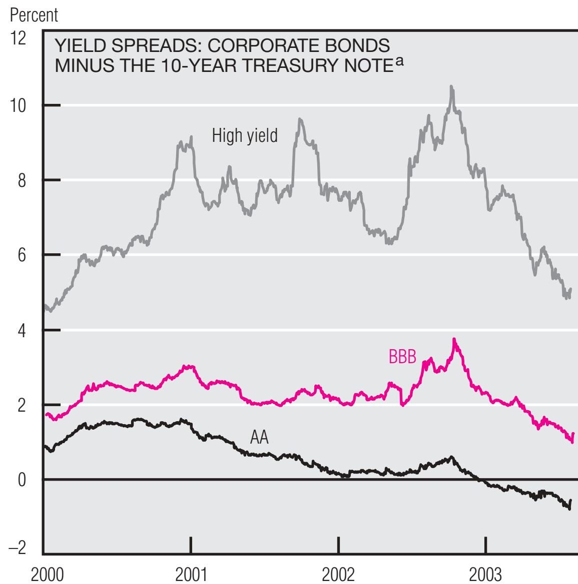

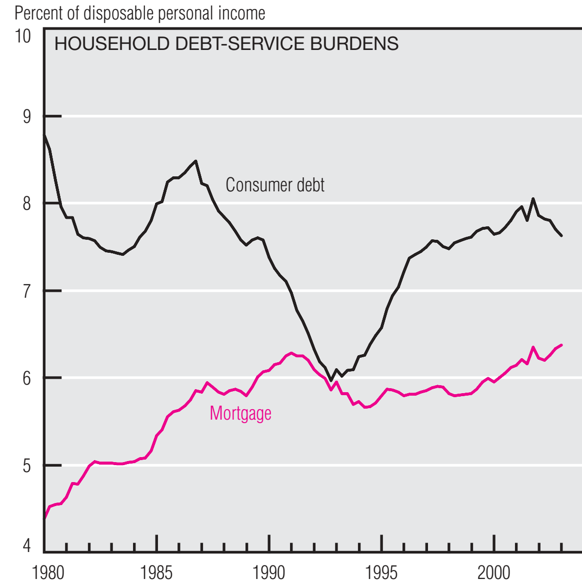

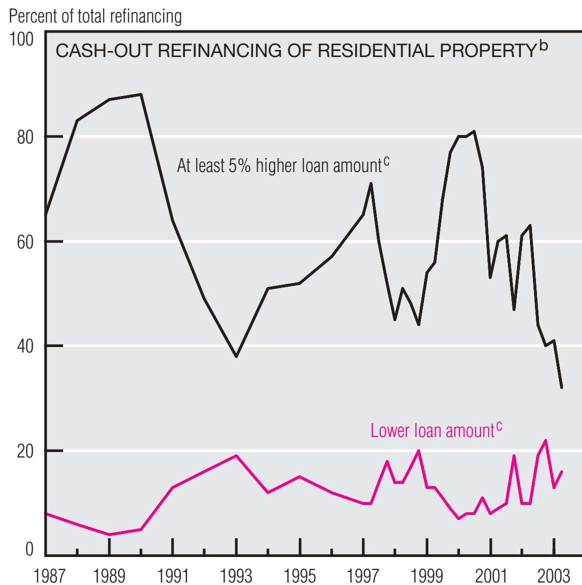

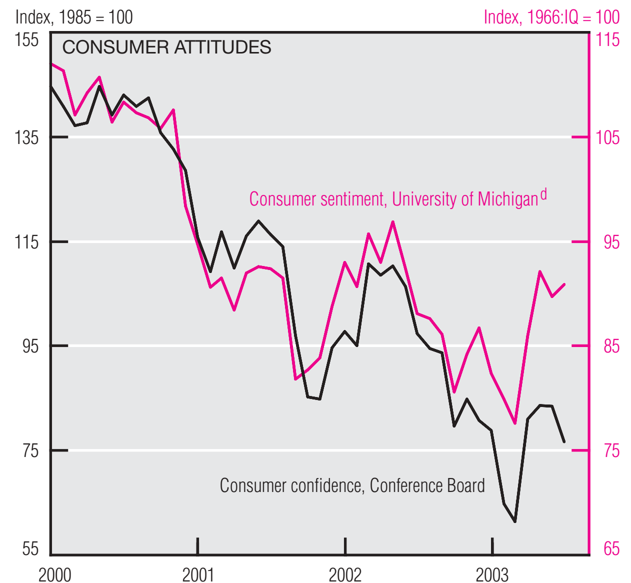

a. Merrill Lynch AA, BBB, and High Yield Master II Indexes, each minus the yield on the 10-year Treasury note.
b. Annual data until 1997, quarterly data after.
c. Compared with previous financing.
d. Data are not seasonally adjusted.
SOURCES: Federal Housing Finance Board; Federal Home Loan Mortgage Corporation; Conference Board; University of Michigan; and Bloomberg Financial Information Services.

their lows, while high-grade corporate bonds increased about 70 bp. Because the rate increases imply a more sanguine economic outlook, yield spreads between bonds of different risk classes drifted down slightly, somewhat tempering the general rise in yields, especially for the riskier bonds.

The consumer sector has been the key source of strength since the recovery began. To some extent, this strength derives from changes in technology and from mortgage markets that have dramatically transformed accumulated home equity from a very illiquid asset into an important tool of household finance, especially during sustained periods of mortgage rate declines. The pronounced drop in conventional mortgage rates has raised concern among some analysts.

Mortgage rates' downward trend has become a major factor for consumer spending in recent years. Increasingly, households have been able to extract home equity by drawing on home equity loan lines of credit, to realize capital gains through the sale of existing homes, and to obtain cash by refinancing existing mortgages (cash-outs). Although total household debt has increased relative to income, lower interest rates have helped moderate the rise in debt service and allowed for greater spending.

What some analysts find disconcerting is the prospect of an ultimate cessation of refinancing if longer-term interest rates stop falling, or worse, if they begin to rise. If the consumer sector slows as a consequence, either investment or net exports will need to accelerate to maintain output growth

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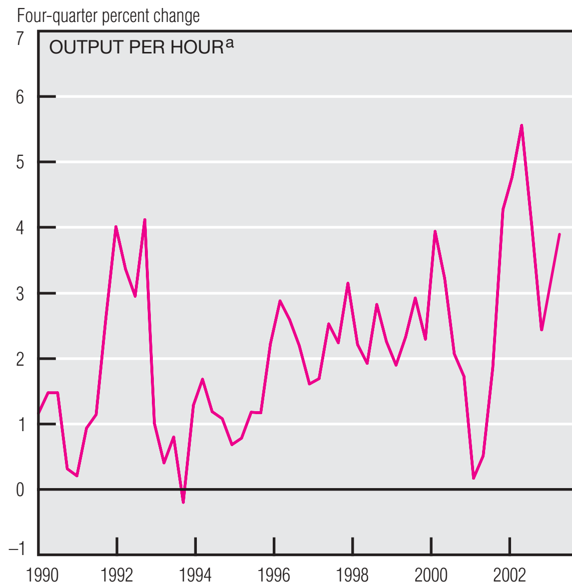
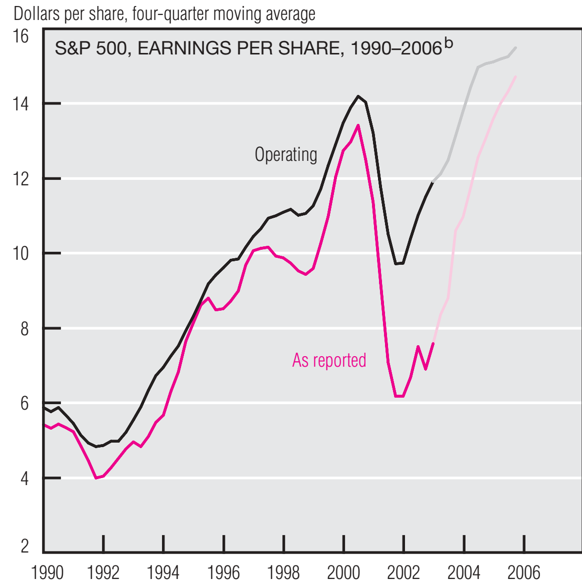
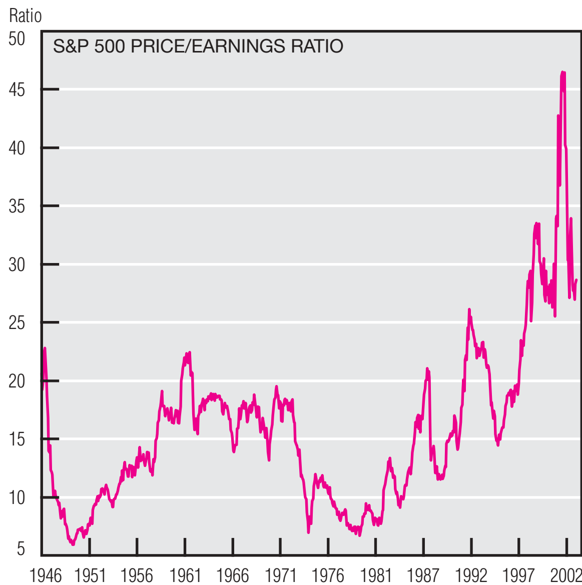
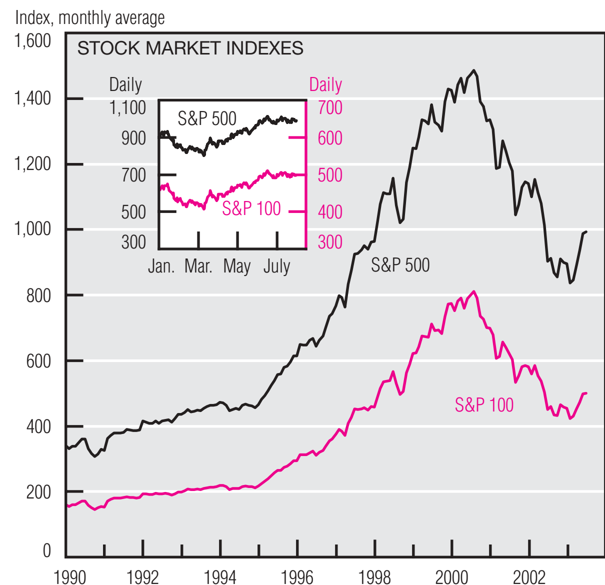
Money and Financial Markets (cont.)









a. Nonfarm business sector.
b. After 2003:IQ, earnings are 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.

at a level that will lead to employment growth.

On the positive side, consumer confidence has risen from the lows it reached before the war in Iraq. Moreover, diminished yield spreads indicate that financial conditions for corporate businesses are improving. Interest rates on investment-grade bonds are quite low by historical standards.

The key basis for optimism, however, comes from longer-term fundamentals, especially productivity as measured by output per hour. Productivity—the ultimate source of economic growth—accelerated dramatically in the mid-1990s, largely because of the growing use of information technology. And 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 productivity growth rates can be sustained over the intermediate term. Indeed, earnings forecasts have been revised upward substantially over the past few months. Furthermore, should higher earnings growth materialize, the recent decrease in the price/earnings ratio might accommodate sustained improvement in the equity market. On balance, major stock indexes like the S&P 500 have climbed noticeably since May, partly owing to less geopolitical uncertainty and to passage of a tax cut package that included a marked reduction in personal federal tax on corporate dividend income.