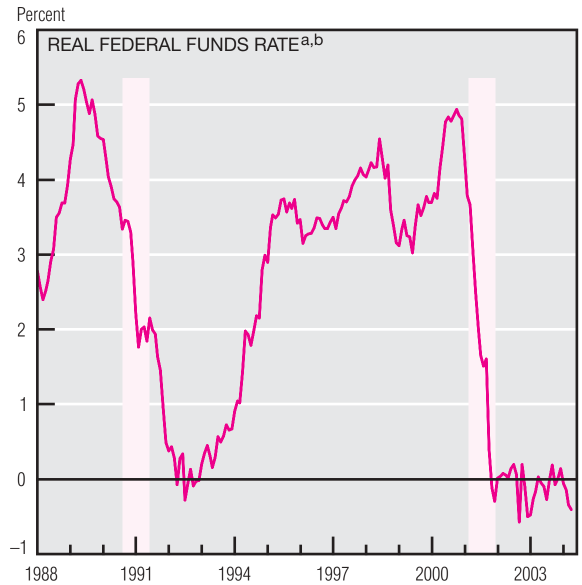
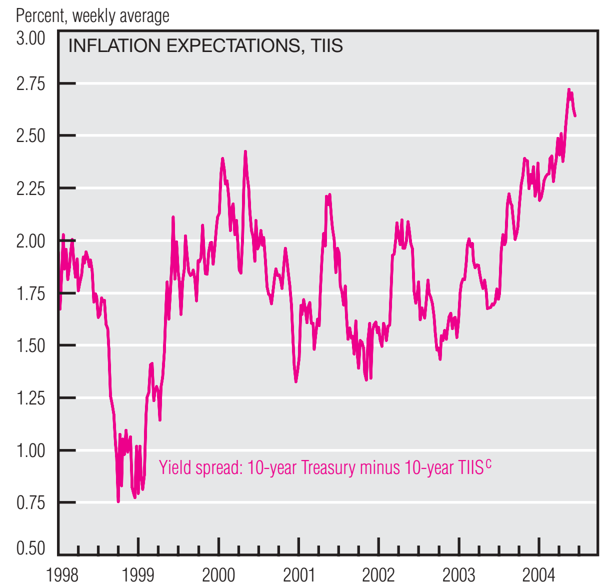
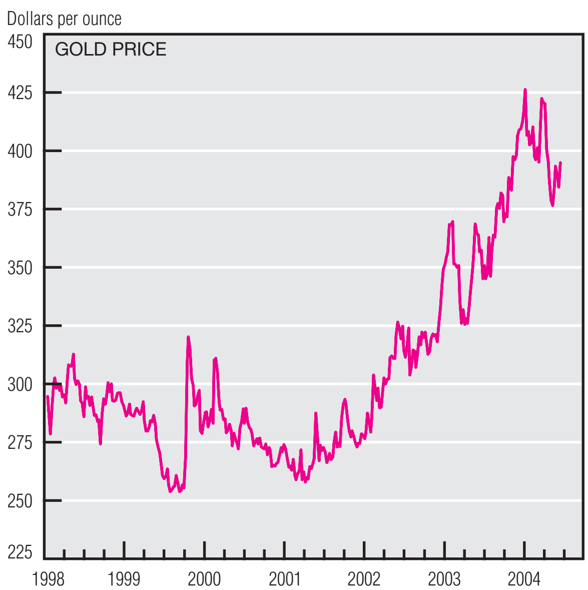
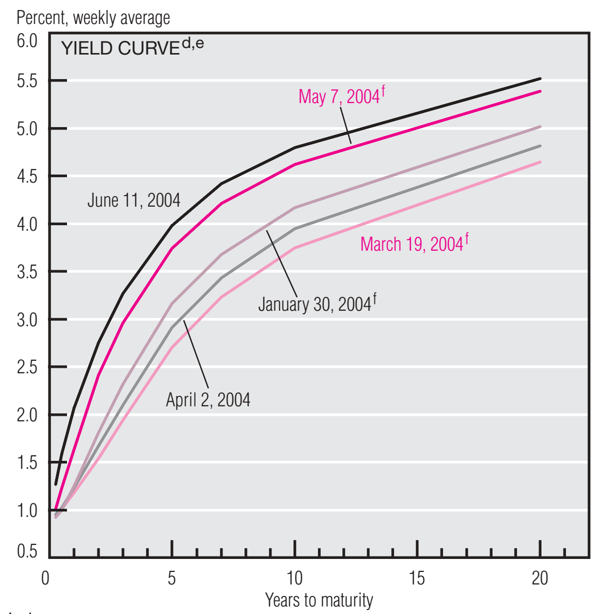
Money and Financial Markets









a. Defined as the effective federal funds rate deflated by the core PCE Chain Price Index.
b. Shaded bars indicate periods of recession.
c. Treasury inflation-indexed securities.
d. All yields are from constant-maturity series.
e. Average for the week ending on the date shown.
f. The first weekly average available after the FOMC meeting.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; and Bloomberg Financial Information Services.

The May 4 statement of the Federal Open Market Committee noted the "accommodative stance of monetary policy." This stance is reflected in current estimates of the real federal funds rate, which is calculated as the nominal federal funds rate minus the inflation rate. By one measure, the real funds rate currently stands at –0.4%.

There is some concern that such a low real funds rate could fuel an inflationary episode, and recent inflation data have reinforced that view. Has this concern affected the public's inflationary expectations? Among several measures of inflationary expectations that can be constructed, an often-cited one is the spread between the nominal 10-year Treasury bond rate and the rate on 10-year Treasury inflation-indexed securities. By this measure, inflationary expectations have trended upward since mid-2003. They were dampened in June, however, possibly because of the market's perception that a funds rate increase is imminent.

Gold prices are sometimes viewed as a harbinger of inflation. Presumably, the threat of higher inflation increases the current demand for gold and therefore its price. But gold also serves as a hedge against a number of other risks; for instance, it is used as a safe haven during periods of geopolitical turmoil, calling into question its usefulness as an inflation predictor. Empirical evidence shows no strong link between gold prices and future inflation.

There recently has been a significant jump in the yield curve at the extreme short end, accompanied by

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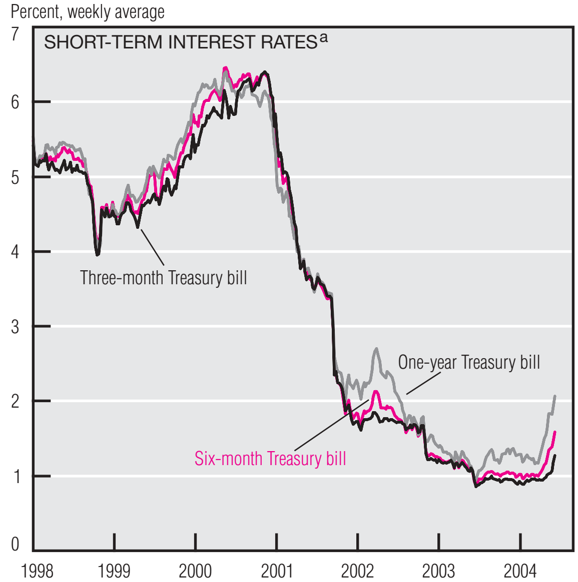

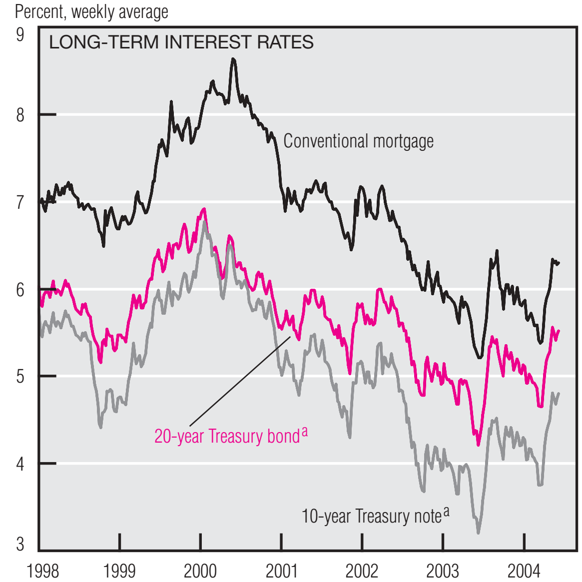

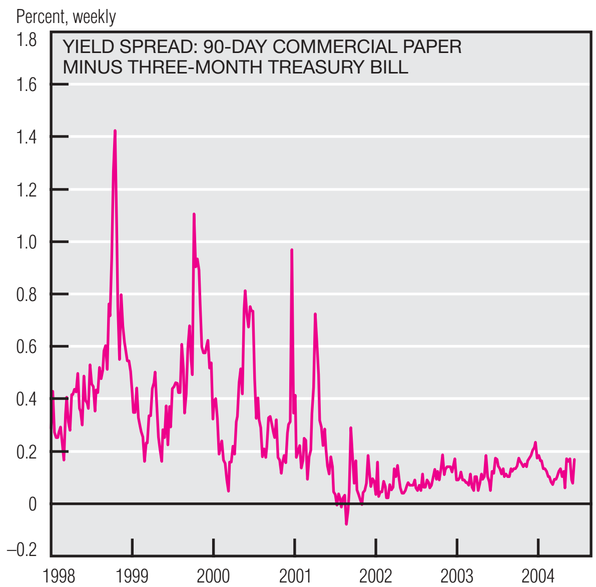

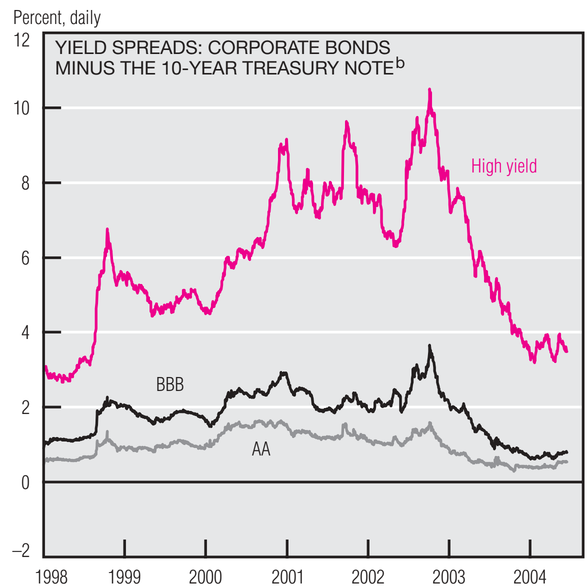

a. Yields from constant-maturity series.
b. Merrill Lynch AA, BBB, and High Yield Master II indexes, each minus the yield on the 10-year Treasury note.
SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," H.15, *Federal Reserve Statistical Releases*; and Bloomberg Financial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

a strong steepening of the yield curve for the shorter maturities. For example, the spread between the two-year Treasury note and the 90-day Treasury bill stood at 50 basis points (bp) in mid-March but is now 175 bp. This steepening reflects market expectations of a series of future policy hikes.

From mid-2003 to early this year, 90-day Treasury bill rates remained near or slightly below the intended federal funds rate. However, these rates have increased nearly 25 bp in the last month and currently exceed the intended federal funds rate by that amount. Yields on six-month and one-year Treasury securities have risen in step over this period, another reflection of an expected imminent change in the federal funds rate.

Long-term interest rates have risen nearly 100 bp since mid-March. The 92 bp increase in conventional mortgage rates has been accompanied by a recent moderation in households' mortgage purchase applications and refinancing activity. Yields on 10-year Treasury securities have increased more than 100 bp since mid-March. Because long-term securities include a premium to compensate the borrower for expected inflation, these increases may reflect expectations of higher long-term inflation.

Risk spreads on short-term commercial paper have remained low, similar to those observed over the last two years, but have shown somewhat more variability over the last month and a half. A longer-term measure of the risk spread, yields on AA- and BBB-rated corporate securities, rose only slightly during the first half of 2004. Although risk spreads on high-yield corporate bonds have fluctuated markedly, they are now near their levels at the beginning of the year.

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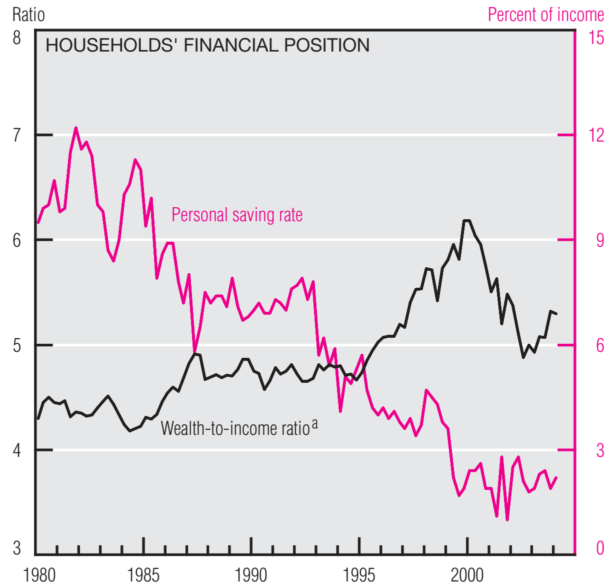

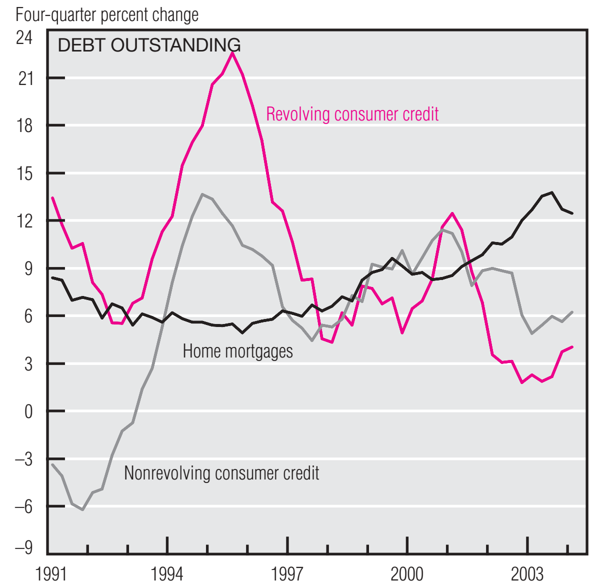

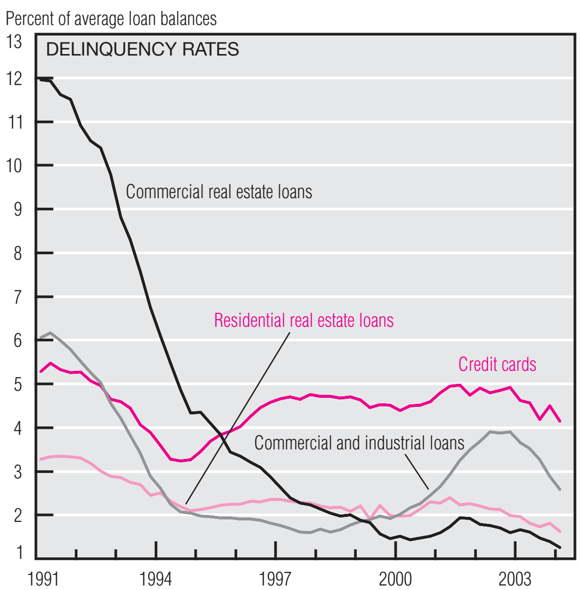

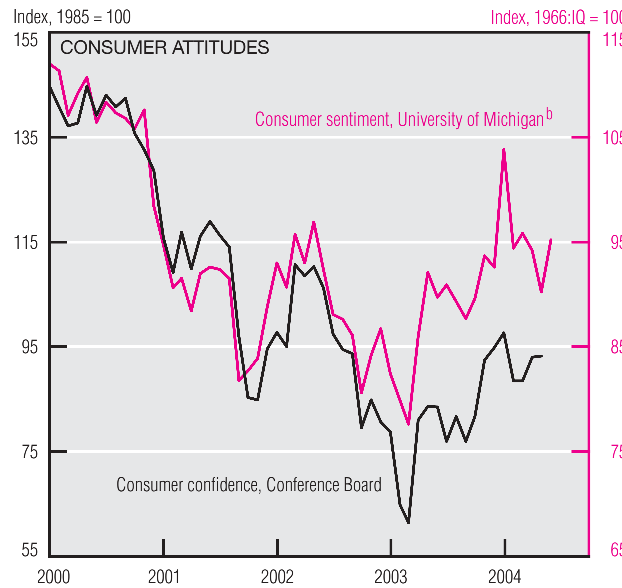

a. Wealth is defined as household net worth. Income is defined as personal disposable income. Data are not seasonally adjusted.
b. Data are not seasonally adjusted.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System, "Charge-Off and Delinquency Rates on Loans and Leases at Commercial Banks," and "Flow of Funds Accounts of the United States," Z.1, *Federal Reserve Statistical Releases*; University of Michigan; and the Conference Board.

Although personal income rose throughout the last quarter of 2003, the wealth-to-income ratio trended upward. A strong stock market and the rising value of real estate assets helped bolster household wealth. However, the upward trend in the wealth-to-income ratio leveled off in 2004:IQ. February's personal saving rate of 2.2% remains low relative to its average of 5.4% over the last 20 years.

Consumer credit growth remains robust, although preliminary April numbers came in below analysts' expectations. Most of the growth in consumer credit in recent quarters has come from nonrevolving credit (car loans, for example), with preliminary April data indicating a decline in revolving consumer credit (credit card debt, for example). Growth in outstanding home mortgage debt moderated early this year, but nonetheless remained robust relative to historical standards. Analysts expect an increase in household debt burdens this year as rising interest rates affect adjustable-rate mortgage debt.

Despite rising interest rates and increasing consumer debt, delinquency rates on consumer loans continue to fall as the improving economy strengthens consumers' abilities to repay debt. Delinquency rates for commercial borrowers show similar improvement.

The preliminary release of the University of Michigan's Consumer Sentiment Index rose moderately in June, more than offsetting its May decline. The expectations component of the index showed the most significant gain. The Conference Board's Index of Consumer Confidence rose substantially in June, with the present situation component exhibiting the largest increase.