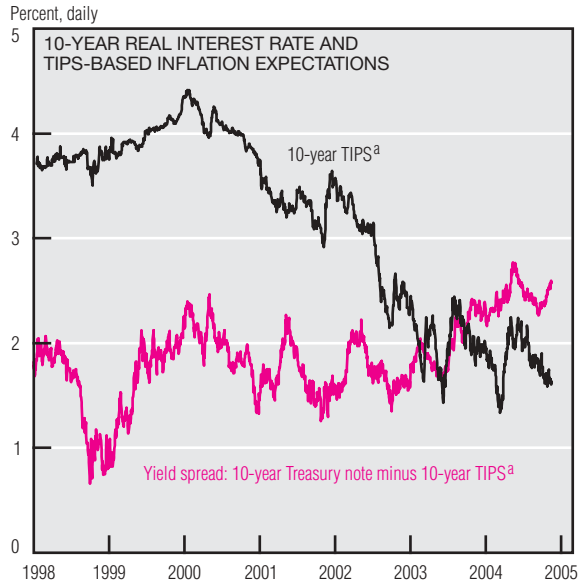
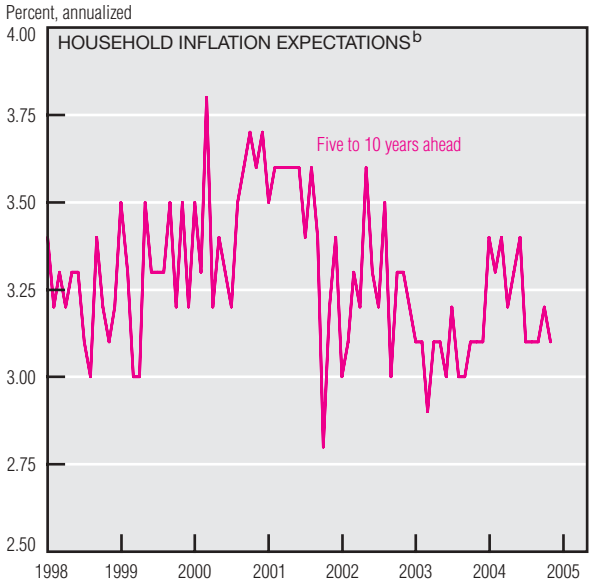
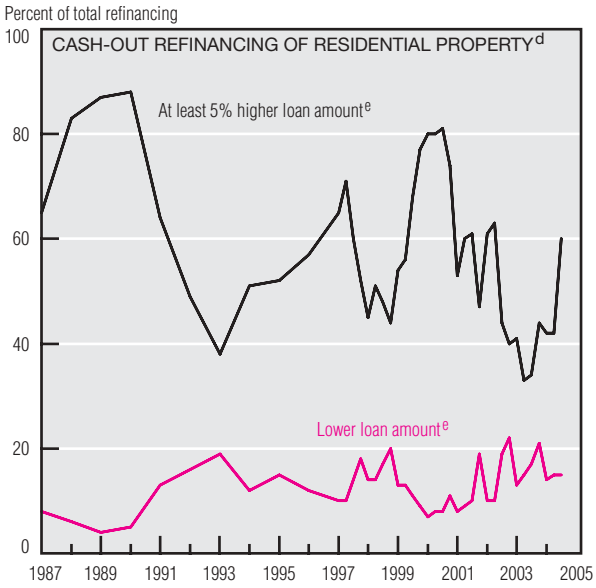
Money and Financial Markets







a. Treasury inflation-protected securities.
b. Mean expected change in consumer prices as measured by the University of Michigan's *Survey of Consumers*.
c. Merrill Lynch AA, BBB, and High-Yield Master II indexes, each minus the yield on the 10-year Treasury note.
d. Annual data until 1997; quarterly data thereafter.
e. Compared with previous financing.
SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; Federal Home Loan Mortgage Corporation; University of Michigan; and Bloomberg Financial Information Services.

In recent months, yields on 10-year Treasury inflation-protected securities (TIPS) have fallen more than yields on nominal 10-year Treasury notes. The spread between the yields on these two securities, which is one measure of inflation expectations, suggests that expected inflation has risen moderately. Presumably, if the declining TIPS yield reflected only weaker economic fundamentals, the nominal rate would decline by an equal amount.

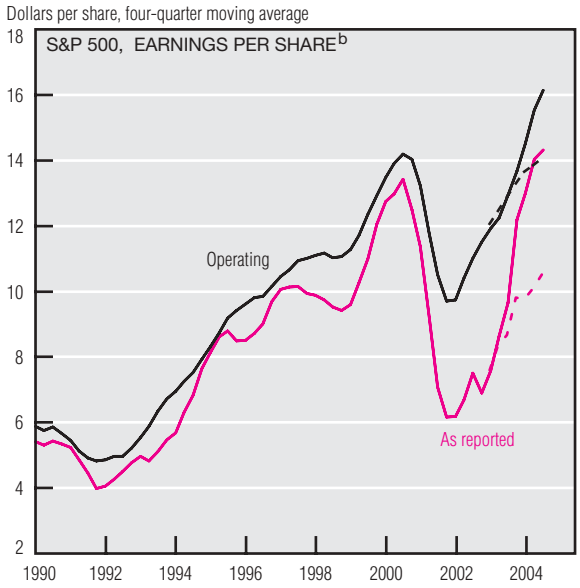
The implied rise in expected inflation is small relative to market fluctuations. The increased spread could thus reflect temporary market factors, especially since the TIPS market volume is relatively small. Moreover, recent survey data on expected inflation do not corroborate the increase.

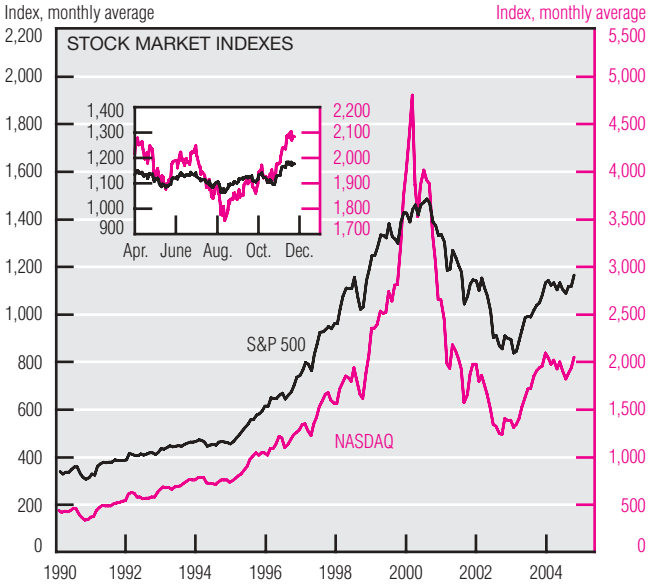
Spreads between corporate bonds and Treasuries have been moderately stable over the past year, reflecting the solid—if not spectacular—state of the economy. Premiums paid on high-yield bonds have in fact diminished somewhat, suggesting increased confidence about the economy's prospects.

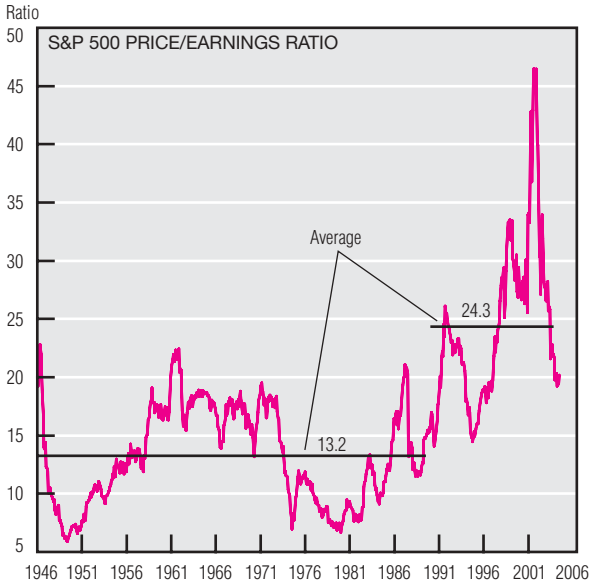
The decline in mortgage rates over the past few months has boosted household liquidity. Refinancing residential property has enabled households to tap their home equity by taking on larger loans. The additional liquidity is a welcome sign for retailers as the holiday spending season begins.

(continued on next page)

Money and Financial Markets (cont.)







a. Nonfarm business sector.
b. Dashed lines indicate forecasts as of March 19, 2003.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Standard and Poors Corporation; and Bloomberg Financial Information Services.

The key fundamental for real interest rates is the economy's growth potential. In the long run, the equilibrium real interest rate approximately equals the productivity growth rate plus the trend employment growth rate. Considering the strong, persistent productivity growth we have witnessed since the mid-1990s, many analysts believe that the real interest rate is somewhere in the range of $3^{1}/_{2}\%$–$4^{1}/_{2}\%$. They are surprised to see yields on long-term bonds so low. On this basis and assuming an expected inflation rate of $1^{1}/_{2}\%$–$2^{1}/_{2}\%$, one might expect nominal long-term Treasuries to eventually rise into the neighborhood of 5%–7%.

The historically high productivity growth of the past year and a half was largely unanticipated, as is evident in the growth of corporate earnings measures relative to their expectations in March 2003. Although analysts expected earnings to rebound somewhat from their 2001 lows, earnings growth has been surprisingly robust. Strong productivity largely offset rising compensation costs, allowing much of recent years' revenue growth to show up on the bottom line of corporate income statements.

The rebound in stock prices over the past two years was thus based on strong fundamentals. Because the rise in stock price indexes was much smaller than the rise in corporate profits, however, the price/earnings ratio has fallen to levels more consistent with historical norms.