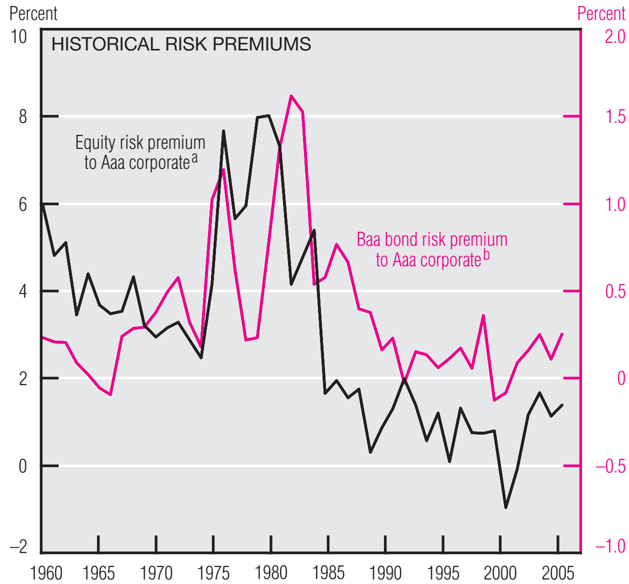
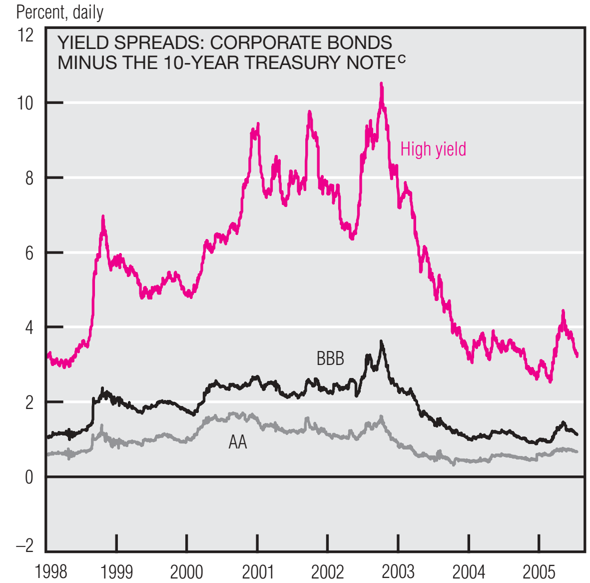
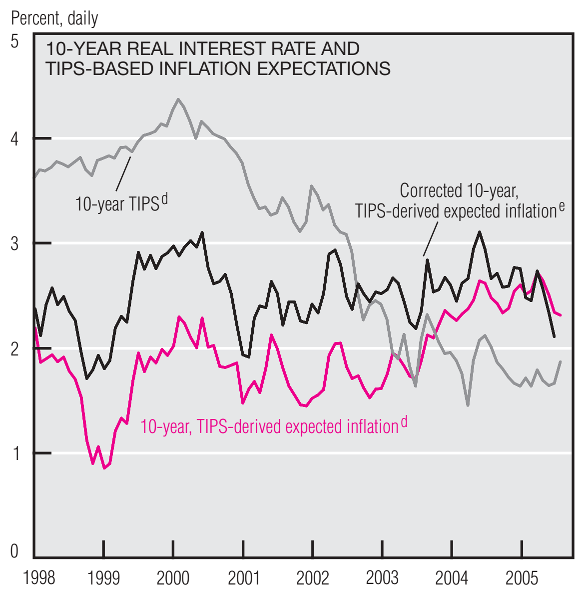
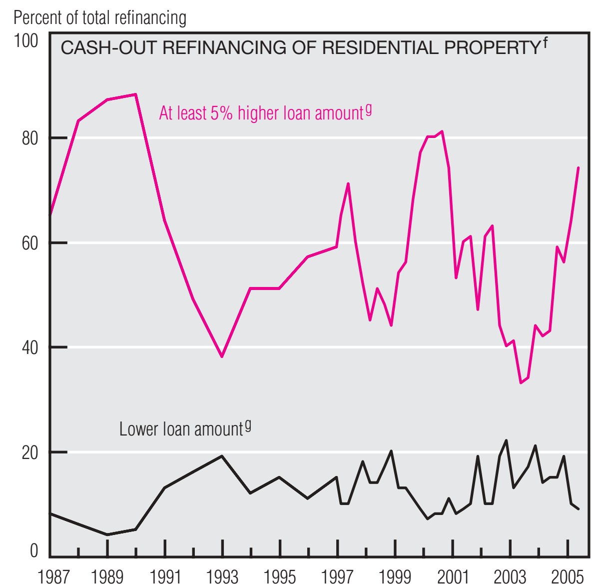
Money and Financial Markets









a. Trend earnings over price minus inflation-adjusted Aaa corporate yield.
b. Default-adjusted Baa corporate yield minus Aaa corporate yield.
c. Merrill Lynch AA, BBB, and High Yield Master II indexes, each minus the yield on the 10-year Treasury note.
d. Treasury inflation-protected securities.
e. 10-year TIPS-derived expected inflation adjusted for the liquidity premium on the market for 10-year Treasuries.
f. Annual data until 1997; quarterly data thereafter.
g. Compared with previous financing.
SOURCES: Board of Governors of the Federal Reserve System; Federal Home Loan Mortgage Corporation; Standard and Poors Corporation; and Bloomberg Financial Information Services.

In a recent speech, Federal Reserve Board Governor Donald Kohn noted that the Federal Reserve pays “a lot of attention to financial market prices in the formulation of monetary policy.” He goes on to say that “[a]n important element in interpreting financial market prices is the identification of the risk premiums they contain.” By risk premium, Governor Kohn means the additional return required by investors for holding a risky security above the compensation that would be demanded by risk-neutral investors, who care only about expected returns.

More specifically, Governor Kohn thinks of risk premiums as “the extra compensation for the uncertainty around anticipated economic and financial outcomes. This compensation is determined by both perception of risks and investor preferences, or risk aversion.” Estimates of the risk premiums for bonds and equity have declined dramatically since the 1970s, when the economy was experiencing high inflation. Although the equity premium is lower now than in the early 1960s (before the great inflation), the bond premium is not. The decline in equity yields over time reflects, to some extent, the markedly reduced variability of both inflation and economic activity that occurred around the mid-1980s, when inflation was brought under control.

Expectations for longer-term inflation can be derived from the difference between the yield on a Treasury

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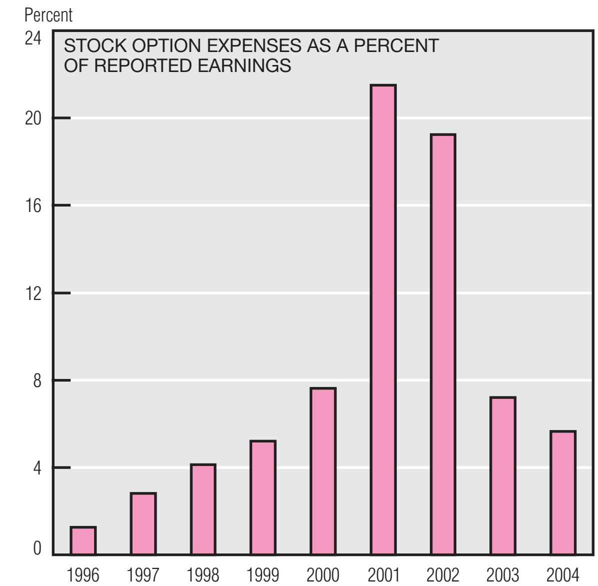
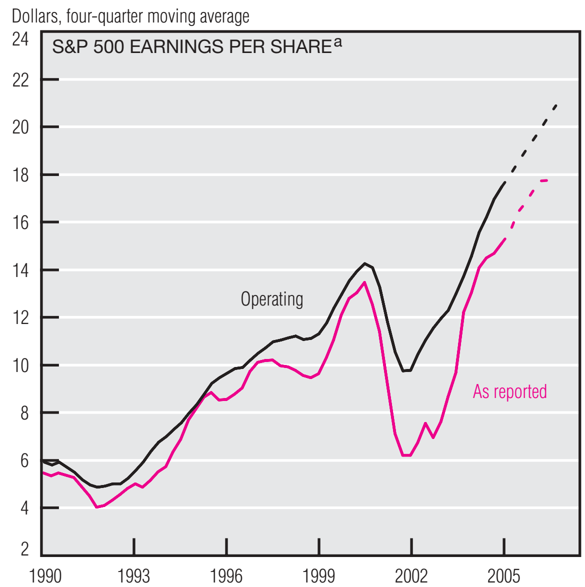
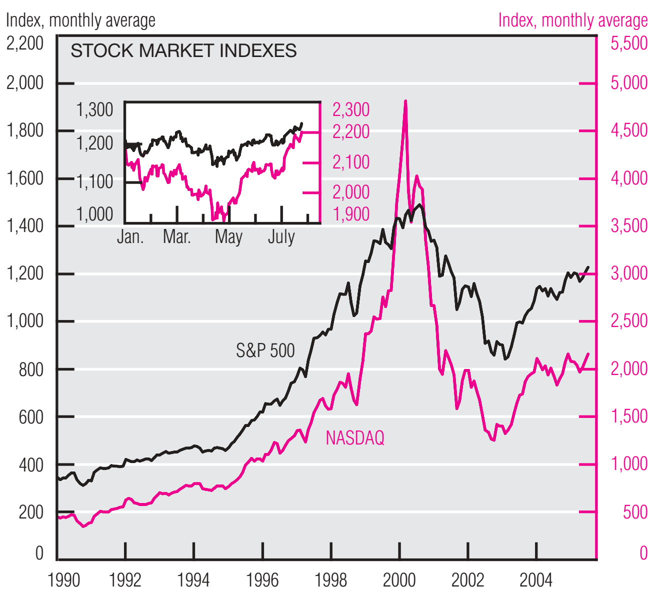
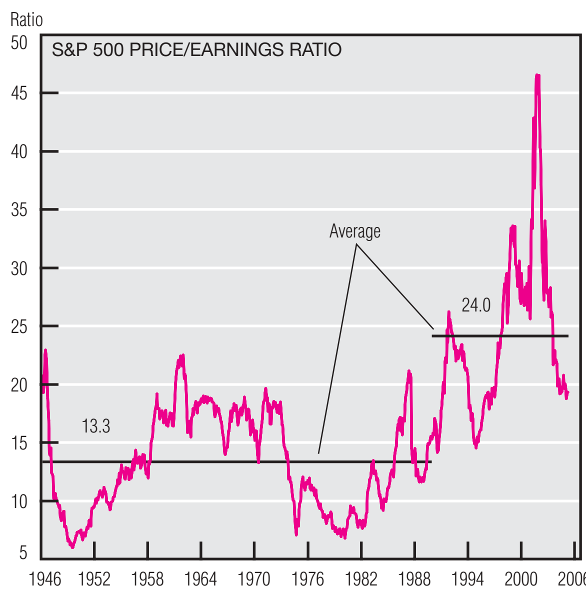
Money and Financial Markets (cont.)









a. Dashed lines indicate the forecast as of July 27, 2005.
SOURCES: Standard and Poors Corporation; and Bloomberg Financial Information Services.

bond and the yield on a Treasury inflation-protected security (TIPS) of the same maturity, adjusted for its liquidity premium. Over the past month, such estimates have suggested a decline in inflation expectations over a 10-year horizon.

The persistence of low long-term nominal interest rates has fueled the housing boom. Moreover, low rates have made mortgage refinancing attractive. Households have used it as a source of funds, refinancing at higher loan amounts and using the extra cash to purchase other goods or pay off installment debt. Some analysts worry that if rates increase substantially, this source of consumer spending power may recede abruptly and precipitate sub par economic growth.

Equity markets fared well in July as earnings reports came in moderately higher than expected. By the month's end, nearly 75% of the firms in the S&P 500 had reported. Interestingly, equity prices seemed unfazed by a new practice regarding employee stock options: For the first time, quarterly earnings were reported net of compensation derived from granting such options.

Going forward, operating earnings of S&P 500 firms are expected to maintain their recent trajectory. Operating earnings projections are based on the aggregate of analysts' expectations for individual firms in the index. Projections for as-reported earnings are based on market strategists' expectations and apply to the S&P index as a whole. Market strategists appear less sanguine than analysts. Both projections, however, bode well for equity valuation, given a relatively low price–earnings ratio.