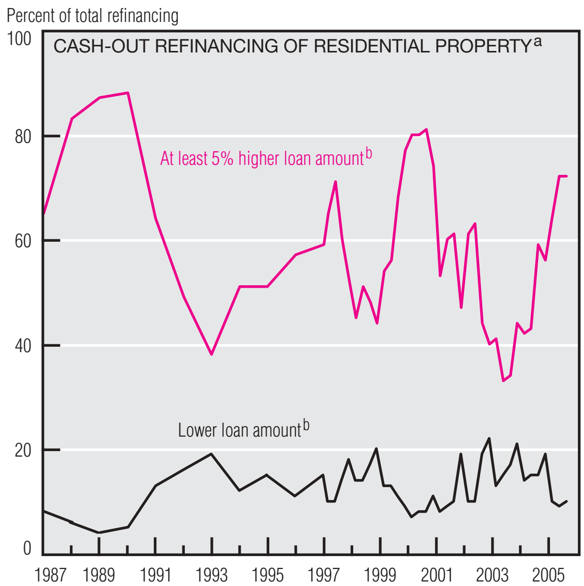
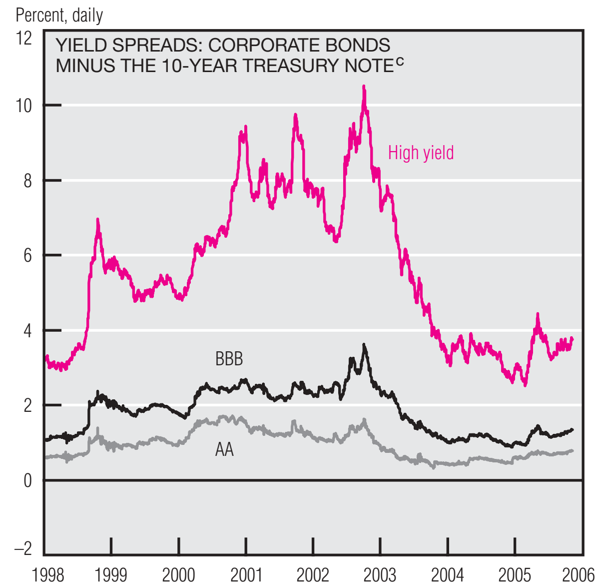
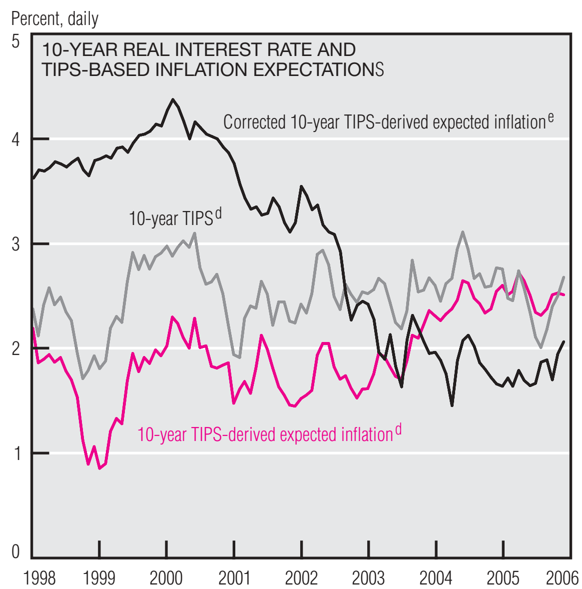
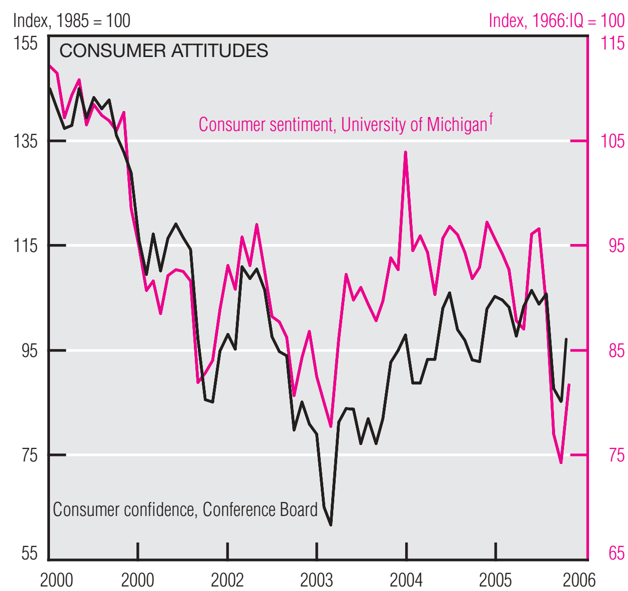
Money and Financial Markets









a. Annual data until 1997; quarterly data thereafter.
b. Compared with previous financing.
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. Ten-year TIPS-derived expected inflation, adjusted for the liquidity premium on the market for the 10-year Treasury note.
f. Data are not seasonally adjusted.
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; the Conference Board; and Bloomberg Financial Information Services.

Despite 12 straight increases in the federal funds rate, long-term interest rates remain low by historical standards. For more than three years, the economy has been expanding at an average annual rate of 3.5%. Normally, when economies expand at such a healthy pace, investment opportunities abound, boosting the real rate of return on new business investment. In turn, the high returns on new capital tend to pull up the whole yield structure, including long-term real interest rates.

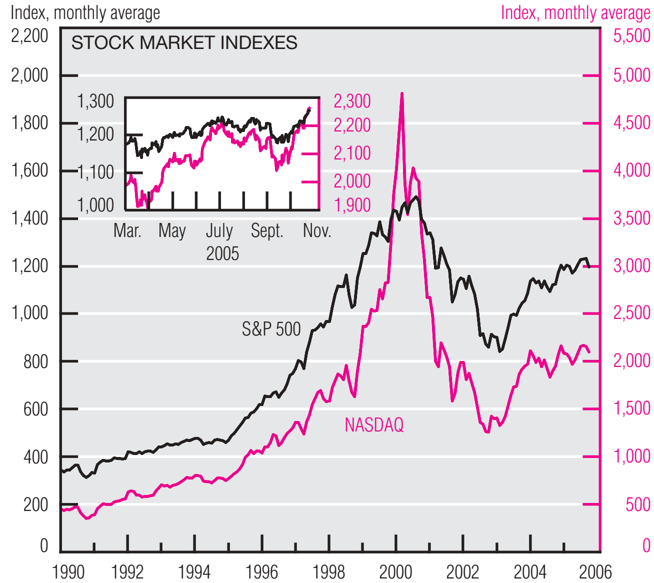
The savings glut in Asia is increasingly viewed as a major damper on the U.S. interest rate structure. The impact of low long-term rates is nowhere more evident than in the housing market. Persistently low mortgage rates have fueled a boom, raising housing prices relative to income levels.

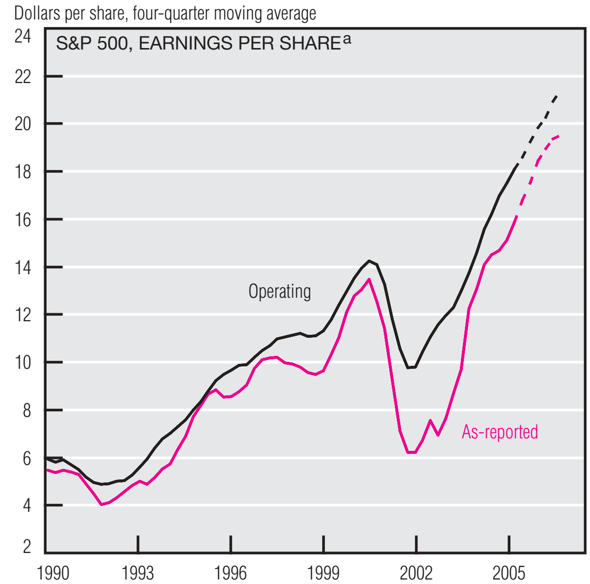
High housing prices and low mortgage rates have combined to give households a substantial source of financing. More specifically, they have enabled households to tap their increased housing equity by refinancing at higher loan amounts. In recent months, this so-called cash-out refinancing has supplied funds that have allowed households to spend at a pace that has exceeded growth in personal income.

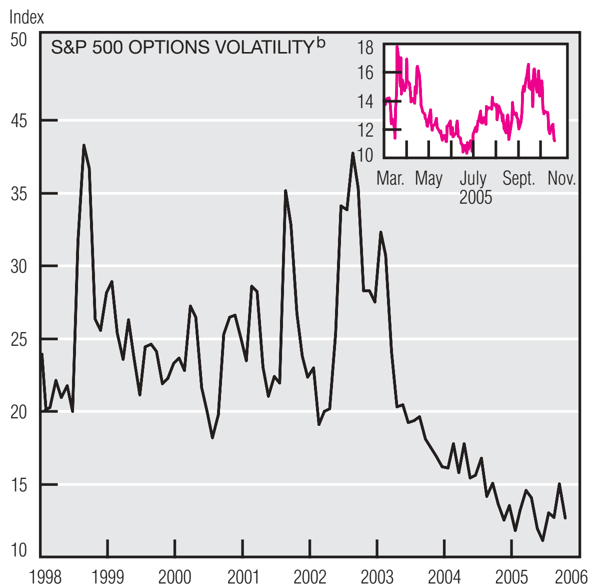
Some analysts are concerned that a sharp uptick in interest rates would stop cash-out refinancing, causing a precipitous drop in consumer spending, especially if housing prices fall significantly. This concern has

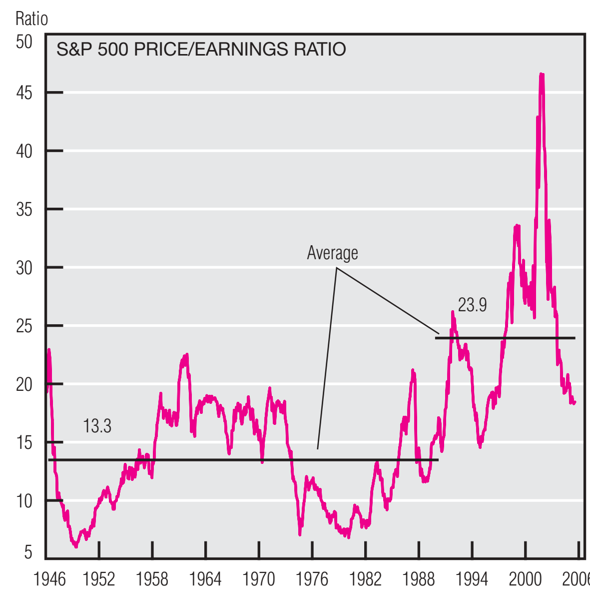
(continued on next page)

Money and Financial Markets (cont.)









a. Dashed lines indicate the forecast as of November 22.
b. CBOE Volatility Index (VIX). Monthly data.
SOURCES: Standard and Poor's Corporation; Chicago Board Options Exchange; and Bloomberg Financial Information Services.

been heightened by higher energy prices, which will put additional stress on household budgets and balance sheets.

Business balance sheets, on the other hand, are quite healthy, as reflected in the stable spreads of corporate bond rates over Treasuries. Many businesses have ample cash for investing if they choose to spend it. With inflation expectations remaining well-contained and consumer confidence on the rebound, business investment should continue to be a major driver of the expansion. Moreover, although consumer spending might slow, it could continue to be supported by employment gains.

Increased business spending is most evident in the energy sector. More broadly, however, improved investment prospects seem to have been supported by a surge in broad equity indexes in November. Indeed, stock market fundamentals appear quite favorable. Chief among these fundamentals are S&P 500 companies' earnings, which have been increasing at a rate of 15% over the past year. Earnings are expected to decelerate, but analysts nonetheless project earnings to grow at nearly double-digit rates over the next year. Despite the recent run-up in stock prices, the price–earnings ratio remains well below its average in recent years.

The strength in equities in November was coupled with a decline in equity options volatility. The decline in volatility since October may reflect some taming of inflation fears.