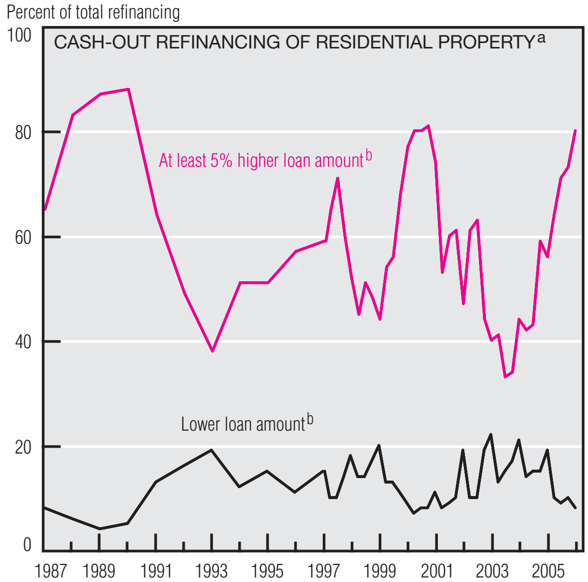
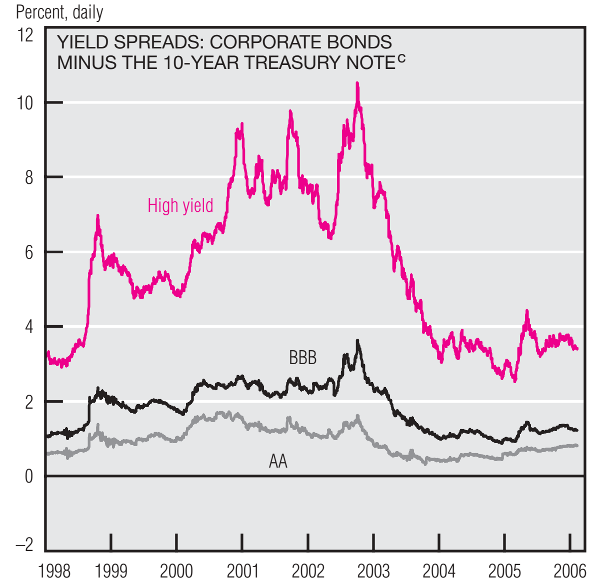
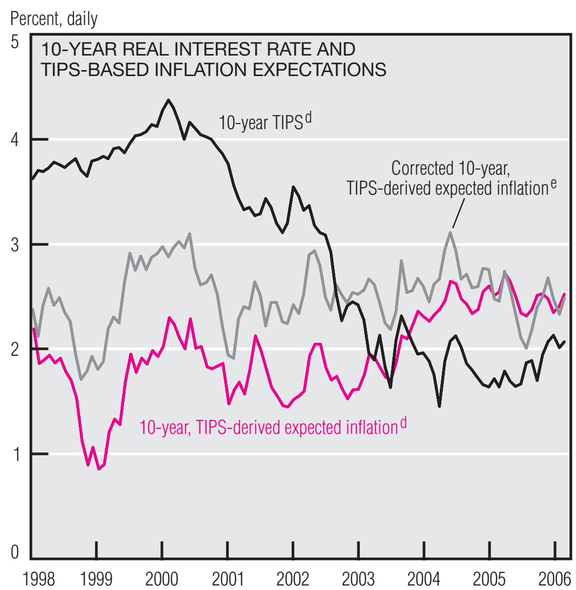
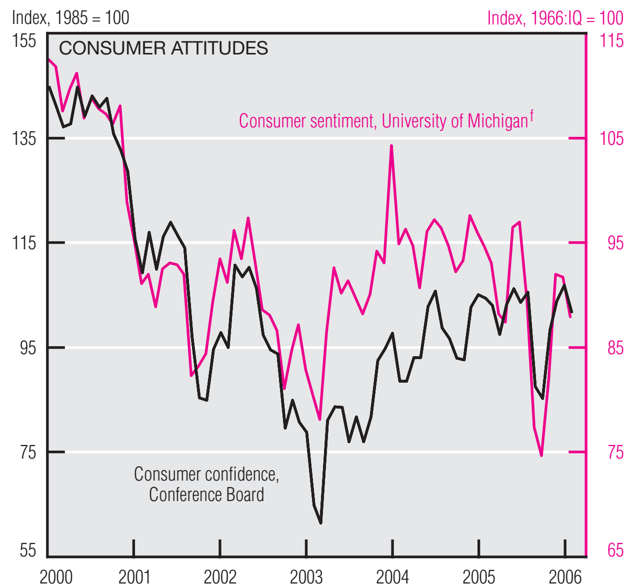
Money and Financial Markets









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.

Long-term interest rates remain low by historical standards, posing something of a conundrum. 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, raising the real rate of return on new business investment. In turn, the high returns on new capital tend to pull up the entire yield structure, including long-term real interest rates.

The impact on the economy of low long-term rates is nowhere more evident than in the housing sector. Persistently low mortgage interest rates have contributed to a housing boom—a situation characterized by a sharp increase in housing prices relative to household income levels.

The housing market is expected to cool considerably this year. A chief concern of many forecasters is that if mortgage rates rise sharply, housing values could plummet. High housing values and low mortgage rates have combined to give households a substantial source of financing. More specifically, households have been able to tap increased housing equity by refinancing at higher loan amounts. This "cash-out refinancing" has provided funds that have allowed households to spend at a pace that has exceeded that of personal income growth in recent months. A sharp uptick in interest rates could halt cash-out

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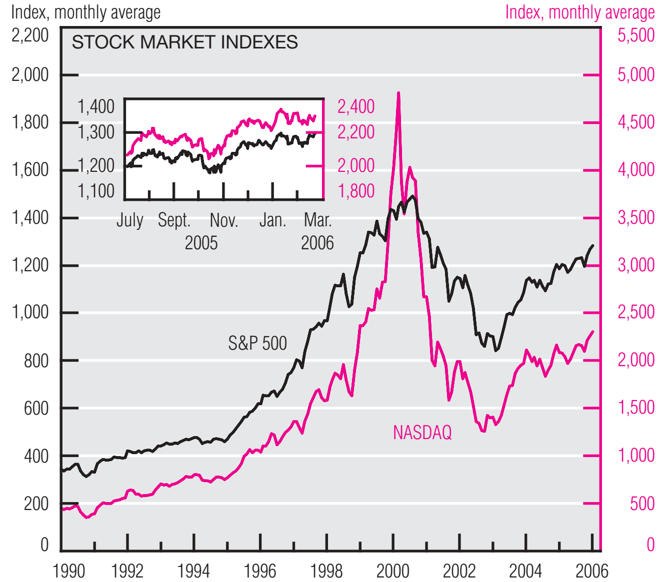

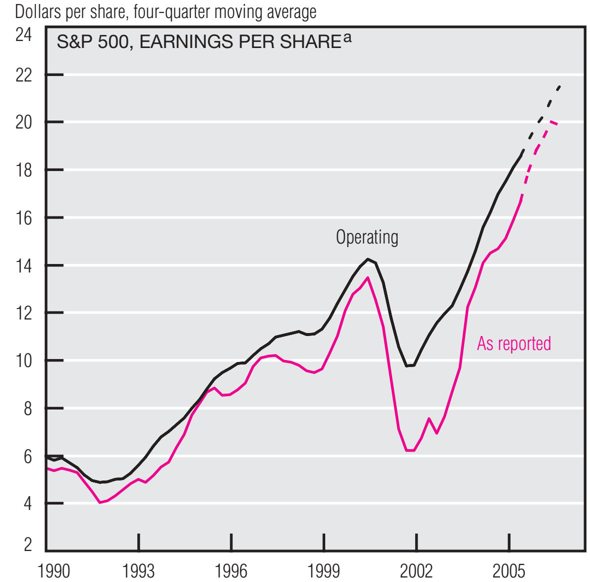

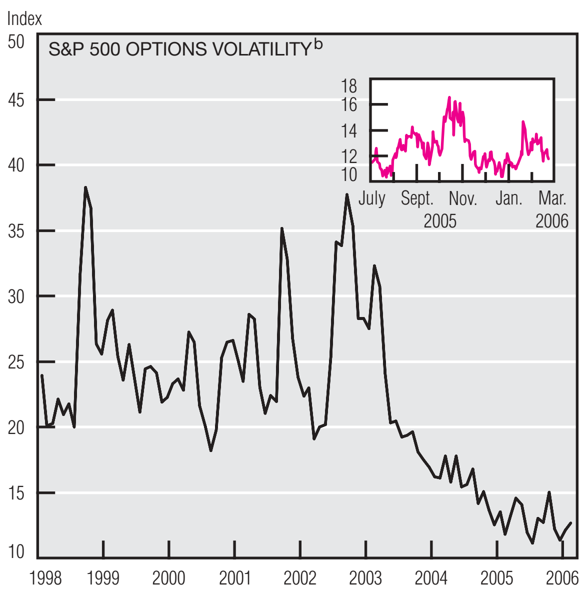

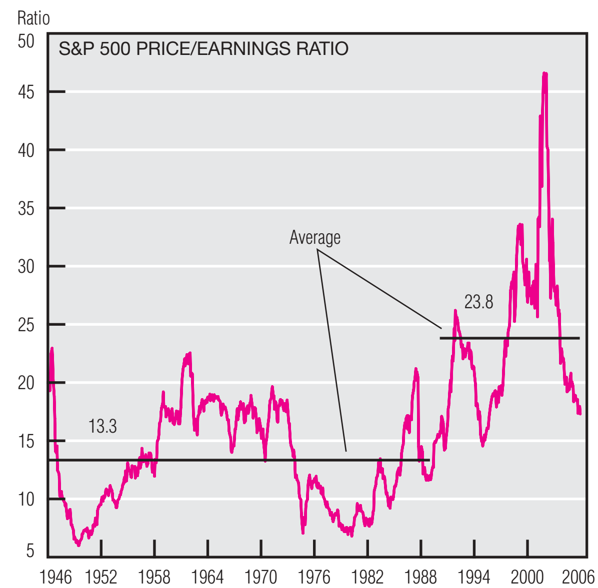

a. Dashed lines represent the forecast as of February 16, 2006.
b. CBOE volatility Index (VIX). Monthly data.
SOURCES: Standard and Poor's Corporation; Chicago Board Options Exchange; and Bloomberg Financial Information Services.

refinancing, causing a sharper-than-expected drop in consumer spending.

Stable spreads of corporate bond rates over Treasury note rates with comparable terms indicate that corporate balance sheets are quite healthy. Businesses have ample cash to invest if they choose to spend it.

With inflation expectations remaining well contained and consumer confidence on the rebound, business investment is expected to supplant consumer spending as the chief driver of the expansion, especially in employment growth. Moreover, although consumer spending might slow, it could continue to be supported by employment gains.

The positive outlook for investment seems to be supported by a surge in broad equity indexes early this year. Stock market fundamentals remain quite favorable, chiefly earnings at S&P 500 companies, which increased at double-digit rates during 2005. Although they are expected to decelerate, their earnings are projected to grow just under 10% during 2006.

Equities' strength since October was coupled with diminished volatility in equity options. The decline in volatility since October may reflect some soothing of inflation fears. Continued progress in reducing inflation over the short term is important to maintaining healthy financial conditions. Despite the recent run-up in stock prices, the price–earnings ratio remains well below its average of recent years.