Recent Capital Market Developments

The nation's capital markets in the first half of 1969 were subjected to steadily increasing pressures, arising both from heavy overall borrowing demands and a tightly restrictive credit policy on the part of the Federal Reserve System. By midyear, interest rates had moved well above levels prevailing at the start of the year and, in most cases, were the highest in this century. Nonetheless, credit flows remained large. Business borrowing increased, spurred by a further growth in capital spending and substantial inventory accumulation. The demands for residential mortgage credit continued strong as home-building activity remained at high levels, and borrowing by Federal agencies to finance the expansion of their activities in support of the mortgage market added to pressures in the securities markets. Aside from the Treasury, state and local governments comprised one of the few major classes of borrowers to reduce substantially their borrowing in the financial markets. This appears, however, to have been due mostly to inability to borrow within their own statutory interest rate ceilings. A large volume of planned state and local issues was postponed during the first half of 1969, constituting a backlog of unsatisfied credit demands which will undoubtedly influence the capital markets in the future.

Commercial banks contributed little to total credit flows in the first half of 1969, but it appears that direct (unintermediated) lending in the financial markets provided a substantial offset to the declining role of bank-intermediated credit. The Regulation Q interest rate ceilings on large certificates of deposit (CD's) resulted in massive losses of time deposits at banks as competing interest rates rose. Much of this deposit money, however, apparently reentered the credit markets through other channels, perhaps principally through investment in commercial paper and Treasury and Federal agency obligations. Moreover, despite the high level of competing rates, deposit inflows to thrift institutions were fairly well maintained and residential mortgage credit continued to expand at a goodly pace though lending terms did tighten substantially further.

BUSINESS FINANCE

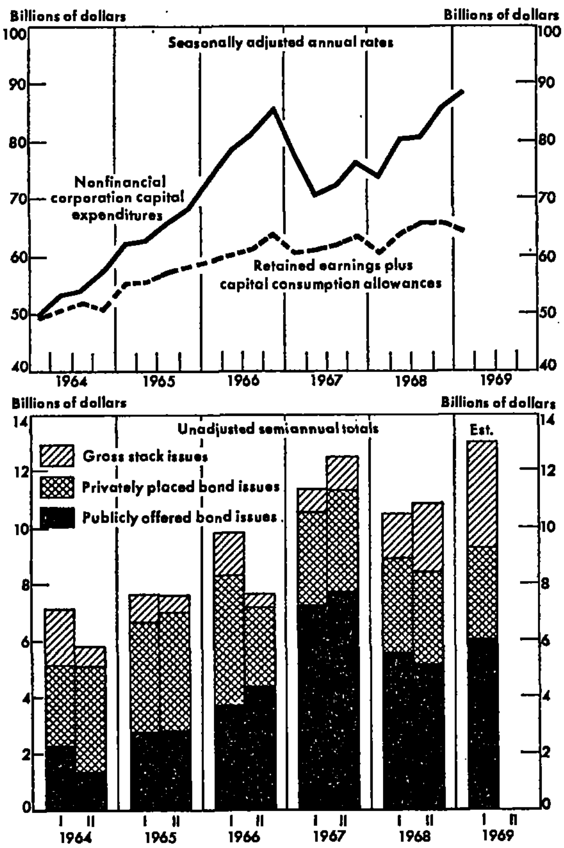
Capital spending by nonfinancial corporations kept on rising at a fast clip during the first two quarters of 1969, and inventory accumulation was also substantial. This increase in expenditures, coming during a period when the growth of internally generated funds was tapering off, resulted in heavy business demands for external financing. Indeed, the gap between capital spending and internally available funds rose to a record seasonally adjusted annual rate of $24¼ billion in the first quarter of the year, almost $2¼ billion above the previous peak set in the fourth quarter of 1966 (see Chart I).

Corporate borrowing in the long-term capital market accelerated during the first six months of 1969. Gross publicly offered and privately placed corporate bond issues totaled an estimated $9.4 billion during the period, almost $1 billion above offerings during the second half of 1968. The increase was centered primarily in public offerings, which rose $850 million to $6 billion, while private placements increased only slightly to approximately $3.4 billion. Corporate bond financing in the first half of 1969 had a decided equity market orientation, as corporations strove to offset the impact of the upward spiral in long-term interest rates. More than 30 percent of the new corporate issues sold to the public during the period was convertible into the common stock of the issuer, a proportion well above that during the last half of 1968 and only barely below the all-time peak reached in the second half of 1967.

Yields on newly issued corporate bonds, after increasing sharply in the last half of 1968, showed little change in the first two months of this year (see Chart II). They surged upward in March, however, amid a generally gloomy atmosphere in the financial markets and did not fully retrace this increase in the easier financial atmosphere that developed in April and May. Moreover, toward midyear, as financial pressures again mounted, yields moved up to new peaks, and some highly rated issues with protection against early redemption were offered to investors at record yields in excess of 8 percent. To avoid being locked

Chart I

SOURCES AND USES OF CORPORATE FUNDS



Sources: Board of Governors of the Federal Reserve System, Federal Reserve Bank of New York, and Securities and Exchange Commission.

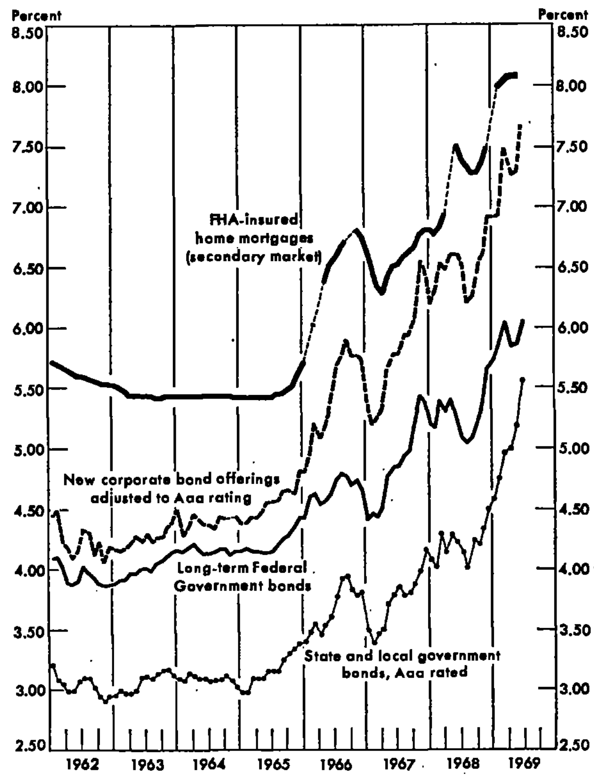
into paying record-high interest rates on long-term bond issues, several corporations issued bonds with shortened maturities in the range of two to five years. Approximately $½ billion of such securities was issued during the second quarter of 1969.

The enlarged needs of corporations for long-term funds during the first half of 1969 were also reflected in a sharp rise in the volume of new common stock offerings. Gross cash offerings totaled a new half-year record of approximately $3¾ billion. This was more than $1¼ billion above the previous record set during the last six months of 1968 and, in fact, only barely below total common stock issues in all of 1968.

Business demands for short-term financing also expanded sharply during the first half of 1969, as inventory investment remained high and trade credit swelled. However, some short-term borrowing may have reflected the unwillingness of these corporations to engage in long-term financing at the peak interest rates prevailing on new bond issues. Indeed, the seasonally adjusted annual rate of increase in business loans at commercial banks over the first half of the year appears to have been about equal to the rapid, 14 percent pace of growth during the second half of 1968. The continued pressure of heavy loan demand by businesses at commercial banks during a period of increasing monetary stringency contributed to a further increase to 8½ percent in the bank prime lending rate in early June. At the same time, corporate financing in the commercial paper market surged. The rise in outstanding open market paper issued by nonfinancial corporations over the first five months of the year appears to have exceeded by a wide margin the record $1.6 billion increase during all of 1968. It is interesting to note, moreover,

Chart II

LONG-TERM INTEREST RATES



Note: Federal Housing Administration-insured home mortgage series plotted through May, all other series plotted through June.

Sources: Board of Governors of the Federal Reserve System, First National City Bank of New York, and Moody's Investors Service.

that nonfinancial corporations have also stepped up sharply their purchases of open market paper, as the rising margin between the rate of return available on these instruments and on commercial bank time deposits apparently induced many firms to invest funds from maturing CD's in the commercial paper market.

There are signs that credit to small businesses has been in increasingly short supply this year and that large corporations may have found it necessary to expand their own borrowing to help finance their smaller customers. Indeed, preliminary data indicate that net trade credit extended by nonfinancial corporations expanded by a record $9 billion (seasonally adjusted annual rate) during the first quarter of 1969, and reports suggest that a further large increase is likely in the April-June period.

CONSUMER AND MORTGAGE FINANCE

During the first quarter of 1969 consumer spending expanded faster than disposable income, resulting in a decline in the personal savings ratio to 6.1 percent. This was the lowest rate for any quarter since early 1966, and was almost ½ percentage point below the ratio during the second half of 1968 (see Chart III). Although outstanding consumer credit continued to increase at a relatively high rate during the first five months of 1969, the $878 million (seasonally adjusted) average monthly rise during the period was about 15 percent below the record pace of expansion recorded during the last half of 1968.

Individuals seem to have exhibited a marked preference for direct investment in the obligations of state and local governments throughout the first half of the year. Preliminary flow-of-funds data show that household acquisitions of municipal securities surged during the first quarter of 1969 to a record $11 billion seasonally adjusted annual rate, equal to more than four fifths of the net increase in such obligations during the period. Moreover, household participation in the corporate bond market has apparently continued at the high level evidenced during the fourth quarter of 1968 as yields available on such securities moved still higher. At the same time, a combination of rising interest rates and sagging stock prices has resulted in a considerable drop in the use of margin credit to finance stock market investments. Margin credit extended by New York Stock Exchange member firms has declined almost without interruption since reaching a peak in June 1968, but the $0.6 billion dip during the first five months of this year was, on a monthly average basis, one-third greater than the decline during the second half of 1968.

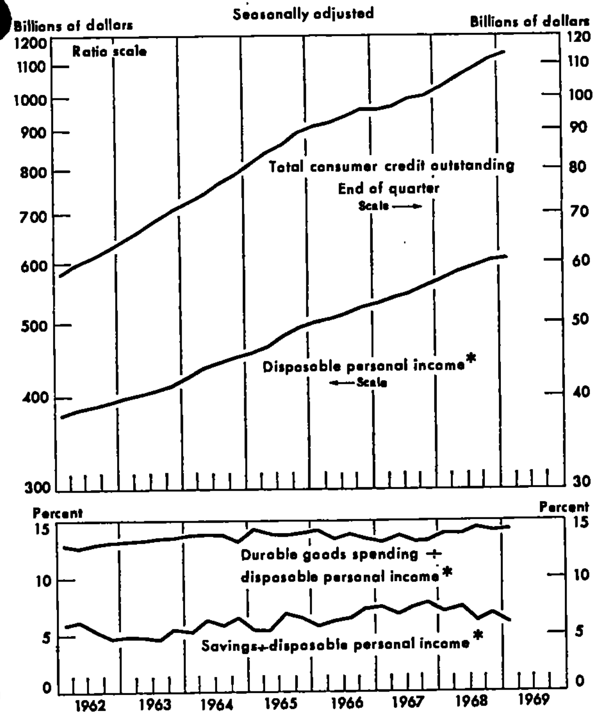
The growth of consumer savings at mutual savings banks and savings and loan associations diminished somewhat during the first five months of 1969, but remained quite strong despite the increasingly attractive yields [illegible] alternative market investments available to consumers. Deposits and share capital increased at a 5.2 percent seasonally adjusted annual rate during the January-May period, only about 1 percentage point below the rate of gain during the second half of 1968. The continued flow of savings into deposit-type institutions reflects in part the efforts by thrift institutions over the past few years to increase the attractiveness of their deposit liabilities by offering longer maturity and higher yielding savings certificates. However, it appears also that the high market rates of interest prevailing over the past several years have resulted in the thrift institutions appealing mainly to the less interest-sensitive savers, with the consequence that the growth in flows to these institutions, while not so spectacular as before, is now much less vulnerable to changes in open market interest rates.

Funds continued to move into the residential mortgage market at a relatively brisk rate in early 1969. In spite of a moderation in the flow of new savings, mortgage holdings at savings and loan associations and mutual savings banks over the first five months of the year rose at a 7.[illegible] percent seasonally adjusted annual rate—about 1 percentage point faster than in the second half of 1968. To finance the widening disparity between deposit gains and the growth of mortgage lending, many thrift institutions borrowed funds from the Federal Home Loan Banks (FHLBs). Advances by the latter to their members—mainly savings associations—rose by almost $1.2 billion during the January-June period. Although this was more than three times the net rise in such advances during the second half of 1968, at the end of June outstanding FHLB advances were still almost $1 billion below the 1966 peak of $7.3 billion. In a further step designed to free more funds for mortgage lending, the FHLB Board in June reduced by ½ percent, to 6 percent, the minimum liquidity requirement imposed on member thrift institutions.

The Federal National Mortgage Association (FNMA) also took steps during the first half of 1969 to increase its support of the home mortgage market. FNMA mortgage purchases surged to $1.2 billion, almost $½ billion more than in the second half of 1968 and barely below the Association's peak rate of mortgage buying in the first half of 1966. Moreover, FNMA participation in the residential mortgage market promises to be sustained at a high level over the near future. At midyear, its outstanding mortgage purchase commitments totaled $2.6 billion, about double the total outstanding at the end of 1968.

Mortgage acquisitions by commercial banks continued

Chart III
HOUSEHOLD SPENDING AND SAVING AND CONSUMER CREDIT
Seasonally adjusted



* Annual rate.
Sources: Board of Governors of the Federal Reserve System, Federal Reserve Bank of New York, and United States Department of Commerce.

at a rapid pace during the early months of 1969, but have since tapered off in an atmosphere of heightened reserve pressure and substantial losses of time deposits. Similarly, life insurance company mortgage holdings expanded sharply during the first quarter of 1969, but reports of a marked rise in policy loans this year suggest some possibility of a cutback in the availability of mortgage credit from this source.

Mortgage debt formation has apparently been spurred this year by innovations in the arrangements for financing apartment buildings. It appears that a growing number of apartment loans now provide institutional lenders with an equity participation, enabling the lender to receive in addition to regular interest some share of net operating earnings and in some cases a portion of the profits from any later sale of the property. This type of arrangement has, of course, greatly strengthened the attractiveness of residential mortgage lending relative to other uses of loanable funds.

GOVERNMENT FINANCE

The flow of new long-term securities offerings from state and local governments abated markedly during the first half of 1969. Gross issues totaled slightly more than $6 billion, almost $3 billion less than in the second half of 1968 and the lowest half-year volume since the last six months of 1966. Interest rates on municipal securities rose almost without interruption, and this forced the cancellation or postponement of a large number of issues which could not be marketed at or below the maximum interest rates legally payable by many state and local borrowers. Reported postponements and cancellations of offerings exceeded $1¼ billion during the first six months of 1969, more than triple the total during the second half of 1968 and more than the deferred borrowing during all of 1966 when state and local government financing was heavily restrained by capital market conditions.

State and local governments have placed heavy reliance on short-term financing in the attempt to offset part of the difficulty encountered in raising long-term funds. Net issues of short-term securities totaled about $2½ billion during the January-June period, by far the largest half-year total ever recorded and more than $2 billion above the volume of such financing during the second half of 1968.

Investor participation in the municipal bond market this year has differed substantially from that of the second half of 1968. Commercial banks, traditionally the major purchasers of such securities, acquired less than 4 percent of the net issues during the first quarter of 1969, a drop of slightly more than 75 percentage points from their share during the second half of 1968. It appears, moreover, that banks may have been net sellers of state and local government securities during the second quarter of 1969 as they attempted to obtain additional funds to satisfy a heavy demand for loans. Reduced bank acquisitions in the first three months of the year were offset by a sharp rise in household sector purchases, and there are signs that this trend continued during the second quarter of the year.

Turning to Treasury finance, Federal revenue and expenditure patterns traditionally result in a budget surplus during the first half of the calendar year and a deficit during the last half. However, the swing to a surplus was especially dramatic this year. The deficit had been $10¼ billion during the second half of 1968, and it now appears that the surplus in the first half of 1969 was about $11½ billion—a swing of nearly $22 billion. Reflecting the greatly improved budget situation, the Treasury retired, on balance, more than $10 billion of its outstanding marketable obligations in the first half of 1969. In the comparable months of 1968, Treasury financing operations had resulted in a small amount of net borrowing.

The easing effect on the financial markets of debt redemption by the Treasury was to some extent offset by the impact of expanded borrowing by the major Federally sponsored credit agencies, especially those that provide direct and indirect support to the residential mortgage market. Faced with increased demand from member institutions for advances, the Federal Home Loan Banking System raised more than $800 million during the first half of 1969, whereas it had engaged in no new borrowing during the second half of 1968. Moreover, to finance the enlarged FNMA purchases of residential mortgages, outstanding obligations of this agency rose by $1.7 billion during the first half of 1969, the largest half-year financing ever undertaken by the Association. Similarly, borrowing by the Federal Intermediate Credit Banks and the Federal Land Banks also exceeded the pace that had been registered during the second half of 1968.

ROLE OF THE BANKING SECTOR

In a period marked by growing reserve stringency, total commercial bank credit appears to have expanded at a very moderate 3 percent seasonally adjusted annual rate over the first half of the year, less than one fourth the rate of increase during the second half of 1968. However, banks were able to maintain loan expansion at a high level by undertaking substantial portfolio adjustments. Their United States Government securities holdings were cut back at an estimated seasonally adjusted annual rate of 18 percent, and they made virtually no net acquisitions of state and local government obligations. All major loan categories registered gains except loans to securities brokers and dealers, which declined at a 23 percent annual rate in response to lightened dealer inventories and to a generally lower level of stock market credit. The almost 14 percent annual rate of expansion in business loans was about unchanged from the pace recorded during the previous half year. Moreover, although real estate lending tapered off during the second quarter, the 10½ percent rate of increase in commercial bank real estate loans in the January-June period was only slightly below the growth recorded during the second half of 1968.

Preliminary flow-of-funds data indicate that during the first quarter of 1969 there was a sharp reversal in the pattern of lending to nonfinancial borrowers. The virtual standstill in overall commercial bank credit expansion was almost completely offset by a surge to $60 billion, at a seasonally adjusted annual rate, in direct lending by households, businesses, and state and local governments. This unintermediated lending provided nearly two thirds of the $91 billion of net funds raised by nonfinancial borrowers during that quarter. In contrast, during the second half of 1968, direct credit flows from these sectors had accounted for only 3 percent of total borrowing.

In the first half of 1969 there was a steady erosion in commercial bank time deposit liabilities, while demand deposits expanded only slightly. The 5 percent seasonally adjusted annual rate of decline in time deposits during the January-June period was the first half-year decline ever recorded, and reflects principally the impact of a marked rundown in outstanding CD's. The increasingly wide differential between yields available on short-term open market credit instruments and the Regulation Q ceilings on interest rates that can be paid on CD's prompted a $7.6 billion runoff in outstanding CD's at weekly reporting member banks between the end of December and late June. In the effort to offset the growing impact of this deposit drain, bank demands for Euro-dollar funds increased sharply. Outstanding liabilities of United States banks to their foreign branches rose to a record $14.1 billion in late June, more than double the amount reported at the start of the year. On June 26, in a move designed to moderate any further flow of Euro-dollars to United States banks, the Federal Reserve Board proposed to impose reserve requirements on borrowings from foreign branches in excess of the daily average amount during the four weeks ended on May 28.

Banks have also been experimenting with other devices in their quest to secure additional loanable funds. These include the sale of loans and of participations in the banks' loan portfolios to their foreign branches and to domestic corporations, and the sale of commercial paper by the parent corporation in the case of banks which are part of bank holding companies. Although these maneuvers do not generally lead to an expansion of total outstanding commercial bank credit, they do lead to a rise in credit flows through the banking system.