The Money and Bond Markets in September

The widespread apprehensions over a possible liquidity crisis that had dominated the midsummer period were dissipated by September, and an increasingly optimistic outlook about the prospects for lower interest rates was evident in the nation's financial markets during most of the month. Even concern over events in the Mideast did not appreciably alter investor expectations of interest rate declines. Major factors underlying the favorable market atmosphere in September were the continuation of comfortable money market conditions and the absence of strong demands for bank credit. Market sentiment was also strengthened somewhat by the auto strike, which was regarded as adding to the near-term sluggishness of the economy.

In this environment, most money market rates continued the downward trend which had been under way since midyear. The Federal funds rate even slipped below 6 percent for a time, generating rumors of a possible cut in the Federal Reserve discount rate. The continued decline in the cost of short-term funds prompted a reduction in the prime lending rate by ½ percent to 7½ percent at several small banks early in September, and at a large Philadelphia bank on September 15. As it became apparent that loan demand was only modest, even at the midmonth corporate tax date, most of the major money market banks followed suit in the week of September 21.

Developments related to the prime rate reduction lent a buoyant tone to all market sectors during most of the second half of the month. This was particularly helpful to the capital market, which was laboring under an extremely heavy new issue calendar. As the month drew to a close, concern over the large volume of offerings scheduled for this market in October caused yields to edge higher, but most new issues were continuing to receive favorable receptions.

Both bank credit and the money supply, which had grown quite rapidly in August, posted small declines in September. Short-term variations in these volatile aggregates, however, should not be overemphasized. The process of reintermediation which began in the wake of the partial suspension of Regulation Q in late June continued through September, giving rise to a further strong increase in large certificates of deposit (CD's) outstanding. Although member bank reserves grew rapidly, most of the increase was associated with this strong expansion of time deposits.

BANK RESERVES AND THE MONEY MARKET

Money market conditions, which had eased progressively during August, remained comfortable throughout September. Over the first two weeks of the month, reserves supplied by System open market operations exceeded reserves drained by operating transactions and the increase in required reserves (see Table I). Despite the generous provision of reserves, the Federal funds rate rose over this period, particularly during the week ended September 9. The cautious accumulation of excess reserves by banks prior to the Labor Day weekend, and a similar buildup in excess reserves by the California banks in advance of that state's Admission Day (a bank holiday which fell on the September 9 settlement date), contributed to upward pressure on the Federal funds rate early in the month (see Chart I). As these pressures abated, the Federal funds rate dropped back to the range of late August. Then, under the weight of substantial excess reserve accumulations, the rate persistently slipped below 6 percent during the September 23 statement week. In the face of the easy tone of the money market, System open market operations absorbed reserves fairly aggressively during that week, more than offsetting the net provision of reserves by other factors. Thereafter, the Federal funds rate returned to the 6 to 6½ percent range in which it had moved earlier.

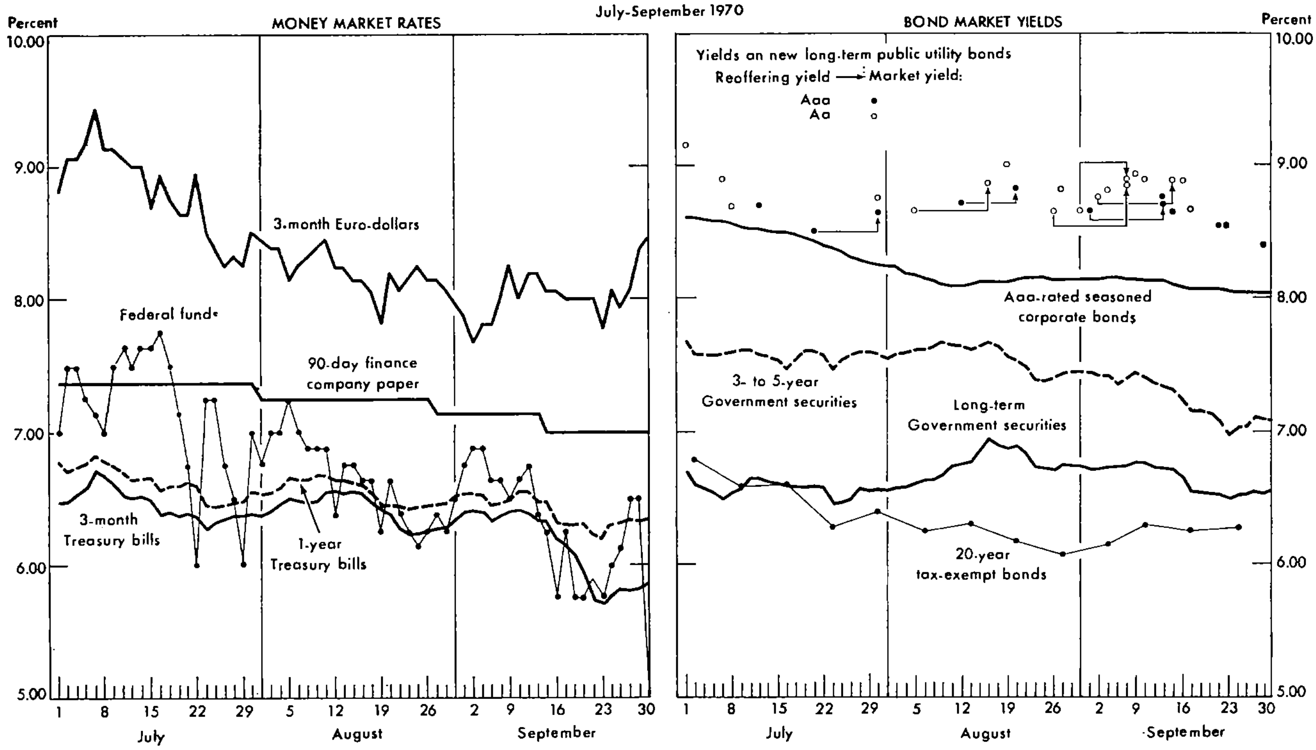
Interest rates on most other money market instruments moved considerably lower in September. On balance over the third quarter, the decline in short-term interest rates has been marked. Rates on bankers' acceptances, prime commercial paper of four- to six-month maturity, and three-month Euro-dollars all declined by 100 basis points or more between late June and the end of September.

This sustained and pronounced downward trend in the cost of short-term funds, combined with a moderation in loan demand in September, provided impetus for the widespread reduction in the prime lending rate—the interest rate charged by commercial banks on loans to their largest and most creditworthy borrowers. Prior to this ½ percentage point reduction, the rate had stood at 8 percent since March 1970.

The general improvement in money market conditions in recent months has also been evident in the decline in member bank borrowings from the Federal Reserve Banks (see Chart II). Severe pressures in the commercial paper market during late June and July had resulted in the transfer of substantial demands for short-term funds from that market to the commercial banks. In turn, the banks borrowed heavily from the Federal Reserve Banks, which fulfilled their historic role as lender of last resort. As fears of a liquidity crisis subsided and pressures on the banking system eased, the level of member bank borrowings declined sharply from an average of $1.3 billion in July to $609 million in September, bringing these borrowings to their lowest level since November 1968.

The commercial paper market, which was still a bit uneasy in August, stabilized further in September. The volume outstanding of commercial paper (other than bank related) increased moderately, following a small decline in August and severe attrition in July. As commercial banks continued to realign their liability structure in the light

Chart I
SELECTED INTEREST RATES
July-September 1970



Note: Data are shown for business days only.

MONEY MARKET RATES QUOTED: Bid rates for three-month Euro-dollars in London; offering rates for directly placed finance company paper; the effective rate on Federal funds (the rate most representative of the transactions executed); closing bid rates (quoted in terms of rate of discount) on newest outstanding three-month and one-year Treasury bills.

BOND MARKET YIELDS QUOTED: Yields on new Aaa- and Aa-rated public utility bonds (arrows point from underwriting syndicate reoffering yield on a given issue to market yield on the same issue immediately after it has been released from syndicate restrictions); daily averages of yields on seasoned Aaa-rated corporate bonds; daily averages of yields on long-term Government securities (bonds due or callable in ten years or more) and on Government securities due in three to five years, computed on the basis of closing bid prices; Thursday averages of yields on twenty seasoned twenty-year tax-exempt bonds (carrying Moody's ratings of Aaa, Aa, A, and Baa).

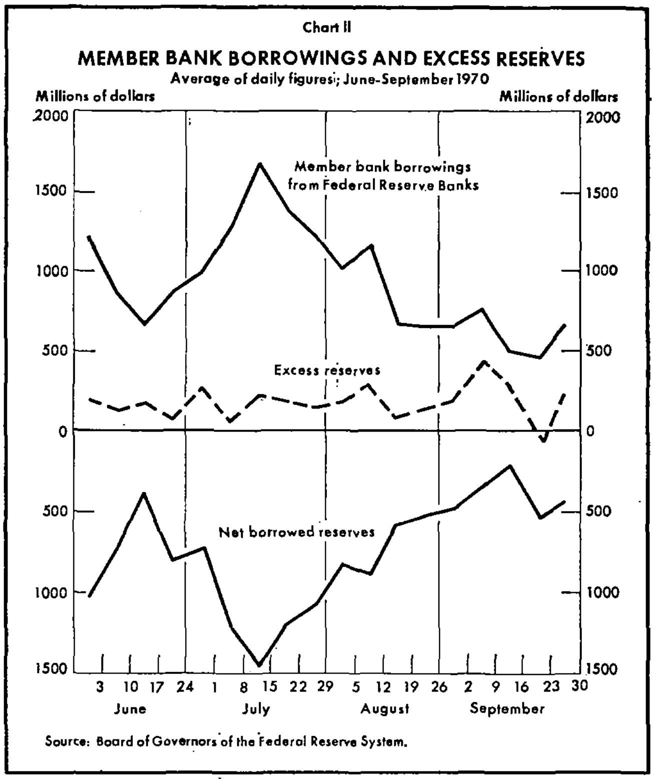
Sources: Federal Reserve Bank of New York, Board of Governors of the Federal Reserve System, Moody's Investors Service, and The Weekly Bond Buyer.

of the August 17 Federal Reserve Board action,[1] the volume of bank-related commercial paper outstanding contracted in September for the second consecutive month. In effect, the imposition of reserve requirements on funds which banks receive from the sale of their affiliates' commercial paper eliminates the special attractiveness of these obligations to the banks. In addition, the reduction in reserves required to be held against time deposits and the partial suspension of Regulation Q in June made large CD's a more desirable source of funds. The net result of these three actions was to place large CD's and bank-related commercial paper on an essentially equal footing.

The moderation in commercial bank lending that occurred during September reflected in part a slower expansion of loans to commercial and industrial borrowers. To some extent, this was related to the considerably lower level of corporate tax liabilities in September relative to the same month last year. As a result of reduced corporate profit margins and expiration of the tax surcharge, corporate tax payments may have been as much as $1 billion less than in September 1969.

Although bank credit contracted slightly during September, banks again received heavy time deposit inflows (see Chart III), as the process of reintermediation which had been under way since late June continued. Despite typically heavy maturities at the September corporate dividend and corporate tax dates, the volume of large CD's outstanding posted a sharp $1.8 billion gain through September 23. This increase brings the level of these obligations outstanding to $22.0 billion—not far below the $24.3 billion level at which they stood at the beginning of December 1968, prior to the severe fourteen-month runoff that amounted to approximately $14.0 billion (see Chart IV).

The narrowly defined money supply—currency held by the public plus demand deposits adjusted—contracted in September at an annual rate of 1.5 percent.[2] The rate of growth of this aggregate over the third quarter averaged 4.6 percent, bringing the rate of expansion so far this year to 4.3 percent. Since the series is erratic and subject to revision, longer time spans are more useful than monthly movements in examining the behavior of the money supply.



The adjusted bank credit proxy, a measure of the liabilities of the banking system, grew more slowly in September than in the previous month. The expansion of the adjusted proxy decelerated from 24 percent in August to 11.8 percent in September, as the rapid growth of time deposits was somewhat offset by the contraction in demand deposits and nondeposit sources of funds.

THE GOVERNMENT SECURITIES MARKET

Optimistic investor expectations about the near-term outlook for interest rates prompted substantial increases in prices of both intermediate- and long-term Government securities in September, although most of the improvement was confined to the second half of the month. An end-of-summer lull in trading activity was accompanied by a cautious atmosphere in early September. Concern that the monetary aggregates might be expanding at an unsustainable rate exerted a restraining influence, and some hesitancy developed as the Mideast situation worsened. Long-term Government securities prices were also slightly depressed by the heavy supply pressures facing the corporate bond market. Nevertheless, selling pressures

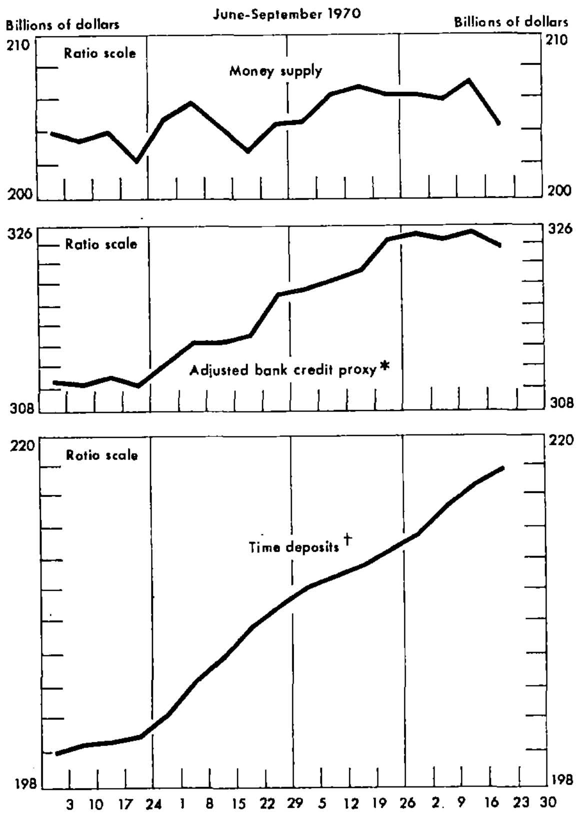
[1] For a discussion, see this *Review* (September 1970), page 213.

[2] Because final September data are not yet available, calculations related to the money supply and bank credit proxy are based on an average of the four weeks ended September 23.

did not materialize, and long-term prices were almost unchanged in the first half of the month. Intermediate-term Treasury obligations benefited early in September from moderate demand by commercial banks, and by midmonth prices were slightly above their end-of-August levels.

Developments in the second half of September were dominated by investor enthusiasm over the prime rate reduction and the prospects of further interest rate declines. The moderate demand for bank loans at the midmonth corporate tax date gave rise to speculation that a general reduction in the prime rate was imminent, and this expectation generated a significant improvement in prices of almost all Treasury obligations during the third week of September. Although to some extent the effects of a general prime rate reduction had been discounted in advance, prices of both intermediate- and long-term Government securities continued to rise sharply following the widespread reductions in this interest rate on September 21 and 22. These price advances were fueled by speculation that the Federal Reserve discount rate might be reduced from 6 percent, since Federal funds were trading below this rate. The announcement on September 23 that the consumer price index had posted only a small increase in August also contributed to the buoyant outlook by suggesting that inflationary pressures might be subsiding. At the close of the month, however, some easing of prices occurred, as participants noted the slightly firmer tone developing in the money market and looked ahead to Treasury financing operations. The Government will refinance $7.7 billion of maturing obligations in November, and market participants also expected a new Treasury cash borrowing in October.

Chart III
CREDIT AND MONETARY AGGREGATES
Seasonally adjusted weekly averages
June-September 1970



Note: Data for September are preliminary.
*Total member bank deposits subject to reserve requirements plus nondeposit liabilities, including Euro-dollar borrowings and commercial paper issued by bank holding companies or other affiliates.
† At all commercial banks.

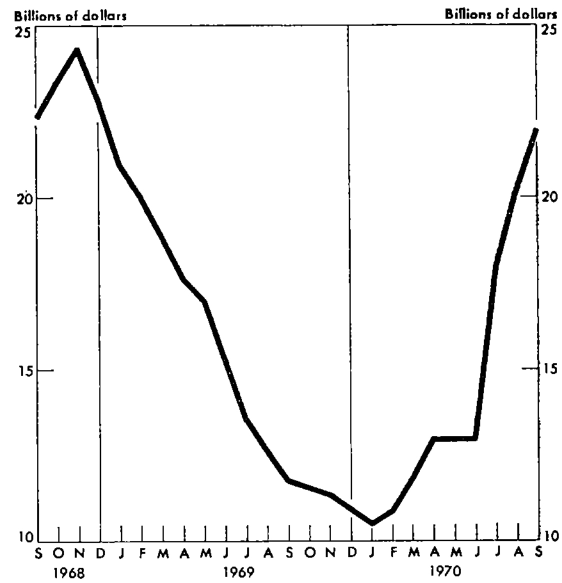
In the Treasury bill sector, dealer inventory positions were quite sizable and retail demand very light as the month began. The occurrence of two weekly bill auctions during the calendar week ended September 4 (because of the September 7 Labor Day holiday) contributed to a cautious tone in the market. Moreover, there was concern in this sector of the market as well that the monetary authorities might have to bring about firmer money market conditions if the monetary aggregates continued to grow as rapidly as they had in August. Investment demand remained generally slack until the September 16 statement week, when stronger commercial bank demand and the optimistic outlook regarding the prime rate reduction caused Treasury bill rates to fall. The favorable effect of the reduction in the prime rate at several major banks on September 21 was seen immediately in that day's bill auction, when the yield on new thirteen-week bills dropped sharply to 5.95 percent, the lowest rate since the March 24, 1969 sale. The yield on the companion 26-week issue also declined markedly, falling to 6.24 percent—its lowest point since March 23, 1970. Bill rates continued to tumble for a brief period after the prime rate reduction, but turned up in the September 30 statement week as a result of the somewhat firmer tone in the market and anticipation of the upcoming Treasury financings.

OTHER SECURITIES MARKETS

Although demands for short-term credit were relatively light in September, a very heavy volume of new taxable and tax-exempt debt was floated during the month. Co porate and state and local government offerings in September amounted to approximately $4.0 billion, one of the largest monthly calendars on record. In part, the sizable volume of new issues in the corporate sector during September apparently continued to reflect the refinancing of short-term obligations and the repayment of bank loans with long-term funds. The volume of corporate financing carried out in the capital market thus far this year has been massive. As of September 30, a total of about $20.0 billion in corporate bond issues had reached the market by comparison with $13.8 billion over the first nine months of 1969. In the municipal sector, the generally lower range of yields during August and September prompted some state and local governments to undertake financings which were not possible earlier this year, when market rates were generally well above the maximum interest rate ceilings that apply in certain localities. In the face of September's heavy supply pressures, prices of both corporate and municipal obligations eased during the first two weeks of the month. As the month progressed, investors' expectations were buoyed by events related to the prime rate reduction, and prices then improved notably. Toward the close of September, however, prices of both tax-exempt and taxable issues again moved downward, as concern over the heavy October calendar and some investor resistance to lower yields developed. But the good reception given to several large issues on the final days of the month steadied the market and revived a more hopeful outlook.

Chart IV

LARGE CERTIFICATES OF DEPOSIT



Note: Latest data are for September 23, 1970.

Source: Board of Governors of the Federal Reserve System.

Developments in the corporate sector appeared to be off to a favorable start when a $175 million issue of New England Telephone and Telegraph Company debentures marketed on the first day of the month received good investor response. The Aaa-rated issue of the Bell System unit was priced to yield 8.65 percent at maturity in forty years—somewhat below the 8.705 percent return on a comparable Bell System financing on August 12. However, investor interest in most other new issues marketed during the first two weeks of the month waned, as the visible supply of new issues burgeoned in the face of an already heavy floating supply of recent offerings. During the two-week period, several underwriting syndicates lifted price restrictions on securities brought to the market in late August, and these issues subsequently traded at a discount. Prices of seasoned issues declined over the first two weeks in very quiet trading activity, as investors marked time awaiting pricing terms on new issues. The downward price slide was halted rather abruptly at the end of the second week, when a new issue touched a favorable price level and sold out quickly, primarily to institutional investors. Smaller issues were also well received, and prices of outstanding corporate securities began to rise. The better tone was subsequently buoyed by the prime rate reduction, and prices continued to advance until investor resistance to the lower range of yields on certain new issues and some profit taking during the fourth week of the month stemmed the rally. However, a good reception was accorded the large issues offered by Western Electric Company and International Telephone and Telegraph Company on the last two days of September, and yields were again declining as the month closed.

Prices of tax-exempt issues followed a similar pattern during September. New issue activity was fairly light early in the month, but a growing calendar and a downward trend in corporate prices kept investors wary. Dealers began cutting prices of both older and new issues, but were unable to reduce their inventories significantly. The full force of supply pressures was felt during the third week of the month when more than one third of the September calendar of tax-exempt offerings, or about $500 million in new issues, was brought to the market. Despite this pressure, however, the week's offerings were very well received as prices were set at levels low enough to stimulate interest. Market participants were encouraged by these

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, SEPTEMBER 1970

In millions of dollars; (+) denotes increase
(—) decrease in excess reserves

Factors	Changes in daily averages—week ended on Sept. 2	Sept. 9	Sept. 16	Sept. 23	Sept. 30	Net changes
"Market" factors						
Member bank required reserves	— 153	— 324	— 69	+ 138	— 315	— 723
Operating transactions (subtotal)	— 30	+ 48	+ 127	+ 474	— 170	+ 449
Federal Reserve float	— 216	+ 378	+ 117	+ 587	— 821	+ 45
Treasury operations*	+ 15	— 78	+ 154	— 124	+ 35	+ 2
Gold and foreign account	+ 27	+ 4	+ 6	— 15	— 210	— 188
Currency outside banks	+ 196	— 170	— 106	— 125	+ 828	+ 533
Other Federal Reserve liabilities and capital	— 54	— 86	+ 46	+ 151	— 2	+ 55
Total "market" factors	— 183	— 276	+ 58	+ 612	— 485	— 274
Direct Federal Reserve credit transactions						
Open market operations (subtotal)	+ 189	+ 370	+ 15	— 942	+ 488	+ 120
Outright holdings:						
Government securities	+ 31	+ 193	— 236	— 358	+ 222	— 148
Bankers' acceptances	— 1	+ 4	— 1	—	— 3	— 1
Repurchase agreements:						
Government securities	+ 133	+ 123	+ 250	— 506	+ 196	+ 196
Bankers' acceptances	+ 13	+ 13	+ 14	— 40	+ 24	+ 24
Federal agency obligations	+ 13	+ 37	— 12	— 38	+ 49	+ 49
Member bank borrowings	—	+ 103	— 263	— 42	+ 205	+ 3
Other Federal Reserve assets†	+ 34	+ 40	+ 54	+ 9	+ 97	+ 234
Total	+ 223	+ 513	— 194	— 975	+ 789	+ 356
Excess reserves	+ 40	+ 237	— 136	— 363	+ 304	+ 82

	Daily average levels					Monthly averages
Member bank:						
Total reserves, including vault cash	28,370	28,931	28,864	28,363	28,982	28,702‡
Required reserves	28,192	28,516	28,585	28,447	28,762	28,500‡
Excess reserves	178	415	279	— 84	220	202‡
Borrowings	660	763	500	458	663	609‡
Free, or net borrowed (—), reserves	— 482	— 348	— 221	— 542	— 443	— 407‡
Nonborrowed reserves	27,710	28,168	28,364	27,905	28,319	28,093‡
Net carry-over, excess or deficit (—)§	94	65	214	210	48	126‡

	Changes in Wednesday levels					Net changes
System Account holdings of Government securities maturing in:						
Less than one year	+ 677	— 487	— 867	+ 660	+ 288	+ 271
More than one year	—	—	+ 93	—	+ 73	+ 166
Total	+ 677	— 487	— 774	+ 660	+ 361	+ 437

Note: Because of rounding, figures do not necessarily add to totals.
* Includes changes in Treasury currency and cash.
† Includes assets denominated in foreign currencies.
‡ Average for five weeks ended on September 30.
§ Not reflected in data above.

Table II

RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS SEPTEMBER 1970

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended on Sept. 2	Sept. 9	Sept. 16	Sept. 23	Sept. 30	Averages of five weeks ended on Sept. 30
Eight banks in New York City						
Reserve excess or deficiency (—)*	20	82	127	— 84	103	50
Less borrowings from Reserve Banks	79	160	89	75	103	101
Less net interbank Federal funds purchases or sales (—)	1,806	2,197	2,100	1,768	1,265	1,827
Gross purchases	2,440	2,778	2,897	2,650	1,979	2,549
Gross sales	634	582	797	882	714	722
Equals net basic reserve surplus or deficit (—)	—1,865	—2,275	—2,062	—1,927	—1,265	—1,879
Net loans to Government securities dealers	1,025	942	776	996	664	881
Net carry-over, excess or deficit (—)†	15	16	50	66	— 23	25
Thirty-eight banks outside New York City						
Reserve excess or deficiency (—)*	35	90	— 12	34	71	44
Less borrowings from Reserve Banks	169	143	98	77	93	116
Less net interbank Federal funds purchases or sales (—)	3,577	4,297	4,677	4,008	3,389	3,990
Gross purchases	5,213	6,039	6,330	5,804	4,912	5,660
Gross sales	1,636	1,742	1,653	1,796	1,522	1,670
Equals net basic reserve surplus or deficit (—)	—3,711	—4,350	—4,787	—4,051	—3,411	—4,062
Net loans to Government securities dealers	1,080	933	1,240	1,047	799	1,020
Net carry-over, excess or deficit (—)†	1	20	57	42	6	23

Note: Because of rounding, figures do not necessarily add to totals.
* Reserves held after all adjustments applicable to the reporting period less required reserves.
† Not reflected in data above.

Table III

AVERAGE ISSUING RATES* AT REGULAR TREASURY BILL AUCTIONS

In percent

Maturities	Weekly auction dates—September 1970: Sept. 4	Sept. 14	Sept. 21	Sept. 28
Three-month	6.365	6.314	5.954	5.807
Six-month	6.555	6.494	6.241	6.373

Maturities	Monthly auction dates—July-September 1970: July 23	August 25	September 24
Nine-month	6.467	6.510	6.237
One-year	6.379	6.396	6.216

* Interest rates on bills are quoted in terms of a 360-day year, with the discounts from par as the return on the face amount of the bills payable at maturity. Bond yield equivalents, related to the amount actually invested, would be slightly higher.

developments, and prices of seasoned issues began to move higher. Demand from commercial banks—particularly for intermediate-term maturities—played an important role in the price increases of these securities. Spurred by general expectations of further yield declines, prices of state and local government issues continued to advance. Subsequently, investors began to consolidate their positions, and some selling pressures caused prices to ease slightly. But the month closed on a favorable note in this sector as well, with most prices edging higher in spite of an extremely large supply of forthcoming tax-exempt offerings. The longer maturities of a number of tax-exempt issues proved difficult to place in September because of lack of interest by institutional investors. As a result, price cutting on these securities was widespread, with corresponding upward pressures on yields. *The Weekly Bond Buyer's* index of yields on twenty municipal bonds rose by 21 basis points to 6.28 percent in the four weeks ended September 24.

Federal agency issues marketed during the month were very well received. The Federal Home Loan Banks' offering on September 10 of $400 million of 7.35 percent one-year bonds and $250 million of 7⅜ percent 26-month bonds had an excellent reception, and these securities rose to a premium in subsequent trading. A $200 million offering of 8⅝ percent Federal National Mortgage Association twenty-year mortgage-backed bonds guaranteed by the Government National Mortgage Association, which had been postponed in August because of less favorable market conditions, was very well received on September 11 and also rose quickly to a premium. Three other major offerings on September 17 encountered very favorable receptions as well. These were $258.2 million of six-month Bank for Cooperatives debentures priced to yield 7.10 percent, $100 million of that agency's three-year debentures offered at 7.30 percent, and $526.5 million of nine-month Federal Intermediate Credit Bank debentures offered at 7.10 percent.