The Money and Bond Markets in June

Interest rates in the money and capital markets generally surged higher during the first half of June, then leveled, and finally resumed their climb toward the end of the month. The continued rapid expansion of the money supply generated apprehension over the implications for monetary policy and the consequences for interest rates. Market observers paid close attention to the gradual but steady climb in the Federal funds rate during the month.

As money market rates pressed up against the bank prime lending rate, a Philadelphia bank lifted its key lending rate by ¼ percentage point to 5¾ percent on June 14, followed on the next day by a California bank which raised its rate to 6 percent. The major money center banks, however, did not follow this lead until early July. Expectations of a general rise in the prime rate and rumors of an increase in the Federal Reserve discount rate diminished after the announcement on June 16 of the Treasury's cash financing. Over the remainder of June, most short-term interest rates continued to rise, closing the month about 30 to 90 basis points above the end-of-May levels. Illustrating the general pattern of rate movements over the month, three-month Treasury bill rates pushed just above 5 percent by mid-June, eased off, and then jumped sharply to 5.22 percent on June 30, 88 basis points above the May 28 rate and the highest level since mid-November 1970.

The rise in capital market yields also halted briefly during the third week of June. Corporate bond prices rallied sharply, as participants took encouragement from the lighter calendar of new bond flotations and from the absence of a general rise in the bank prime lending rate. The improvement in the corporate market extended to the market for Treasury coupon issues. Concern over inflation reemerged on June 21, however, when the Bureau of Labor Statistics announced a sharp increase in the consumer price index during May, and the prevailing market atmosphere turned gloomy once again. On balance, yields on intermediate-term Treasury coupon issues rose 55 to 85 basis points, while yields on long-term maturities increased by 4 to 29 basis points. Tax-exempt yields, as measured by *The Weekly Bond Buyer's* twenty-bond index, climbed by 37 basis points from late May to late June. Corporate bond yields, however, ended the month slightly below their late-May levels.

THE MONEY MARKET

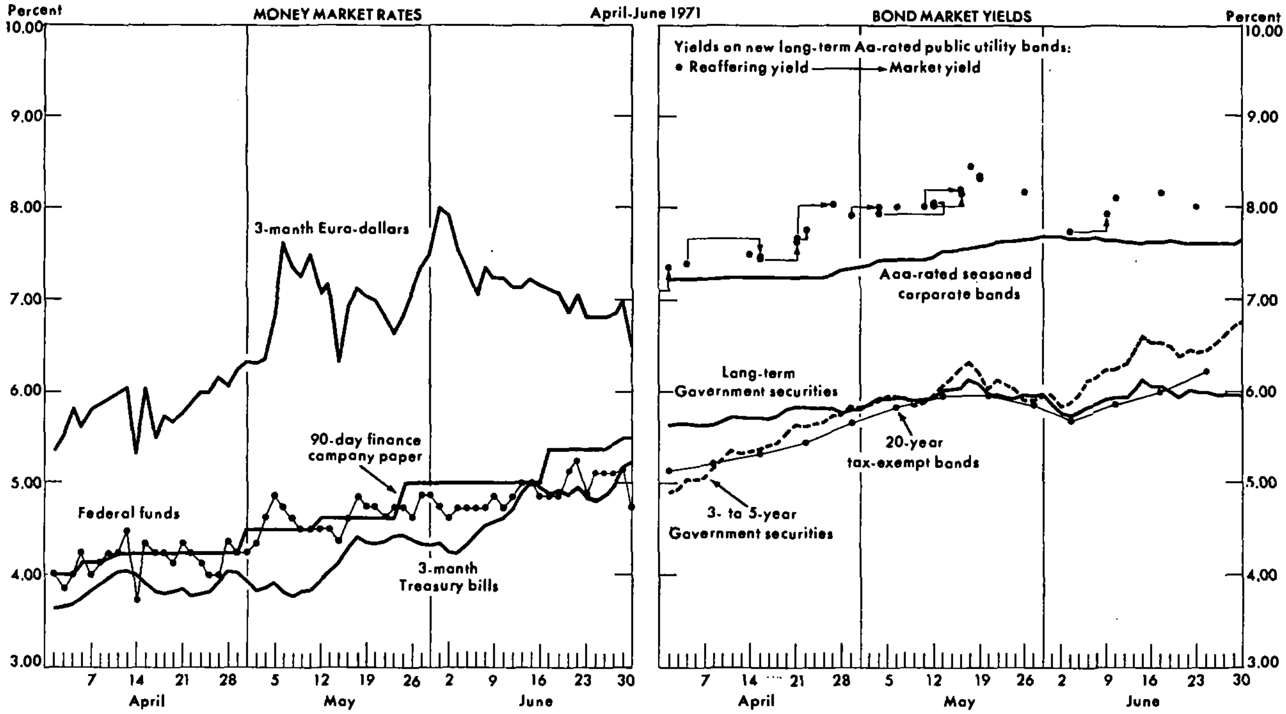
After stabilizing in the latter part of May, money market rates rose sharply in the first half of June. The uptrend across a broad spectrum of rates triggered an increase in the bank prime lending rate to 5¾ percent at a large Philadelphia bank on June 14 and to 6 percent at a California bank. The major money center banks, however, maintained the prevailing 5½ percent rate throughout June. Banks may have been reluctant to raise the prime rate at that time because loan demand exhibited only moderate strength over the mid-June dividend and tax dates. During the month, the effective rate on Federal funds averaged 4.91 percent (see Chart I), up 28 basis points from May and the highest monthly average since November 1970. In addition, the rate most frequently quoted on new 60- to 179-day negotiable certificates of deposit (CD's) at large New York City banks rose 38 to 50 basis points from the end of May. Major finance companies raised their offering rates on ninety-day commercial paper by ½ percentage point to 5½ percent, and dealers raised offering rates on ninety-day bankers' acceptances by ⅝ percentage point to 5⅝ percent.

Total reserves of member banks decreased by $231 million (not seasonally adjusted) on a daily average basis from May to June. Member bank borrowings from the Federal Reserve Banks rose to an average of $514 million in June (see Table I), up $302 million and the highest monthly level since September 1970. Thus, nonborrowed reserves decreased by $533 million in June. Member banks of the Federal Reserve System had net borrowed reserves averaging $286 million during June, compared with a net free reserve position of $6 million in May. During the two statement weeks ended June 16, a rapid decline in the Treasury's balances, associated

Chart I

SELECTED INTEREST RATES

April-June 1971



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 Treasury bills.

BOND MARKET YIELDS QUOTED: Yields on new 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.

partly with the redemption of special Treasury certificates held by foreign central banks, injected $920 million of reserves. However, the subsequent rebuilding of those balances over the remainder of the month drained about $1.4 billion of reserves, more than offsetting the earlier injection.

The closely watched monetary aggregates continued to expand rapidly during June, though the rates of increase in the popular measures of the money supply were considerably below the very fast May rates. Over the second quarter, M_1—currency plus demand deposits held by the public—rose at an 11½ percent seasonally adjusted annual rate (see Chart II), compared with the 8.9 percent rate of expansion recorded in the first quarter and the 5.4 percent rate during all of 1970. The broader measure of the money supply, M_2—defined to include M_1 plus commercial bank savings and time deposits other than large CD's—grew at a 12½ percent annual rate in the April-June period, but this was below the extraordinary 17.8 percent rate of expansion in the first quarter. The slowdown reflects a diminution in the growth of commercial bank savings and time deposits following the unusual growth that occurred during the first quarter of 1971, when yields on competing market instruments fell sharply.

The adjusted bank credit proxy—member bank deposits subject to reserve requirements plus certain nondeposit liabilities—also grew more slowly in the second quarter than in the previous period. The credit proxy rose at a 6½ percent seasonally adjusted annual rate over the April-June quarter, compared with a 10.9 percent expansion rate in the preceding quarter. The more modest second-quarter growth of the bank credit proxy, by comparison with money supply expansion, reflects the fact that over most of the April-June period Treasury deposits and non-deposit liabilities fell while the rate of growth of CD's slowed. During June, however, banks bid aggressively for CD's as market rates advanced, and the level of CD's outstanding at all weekly reporting banks rose by roughly $500 million over the month. After the downtrend in the first five months of 1971, liabilities to foreign branches at all weekly reporting banks bottomed out at the end of May and then rose to an average level of $2.0 billion for the five weeks ended June 30, up $100 million from the average over the preceding five weeks.[1] The narrowing of the spread between domestic and foreign rates has apparently reduced the incentive for banks to continue repaying Euro-dollar borrowings from their foreign branches. Bank-related commercial paper has also leveled out and has remained fairly stable at $1.7 billion since mid-May.

THE GOVERNMENT SECURITIES MARKET

Prices of United States Government securities declined sharply over the first half of June, following the short-lived rally that extended from late May into the first few days of June. The steady price erosion reflected the highly sensitive market atmosphere, as participants focused their attention on the continued rapid expansion of the monetary aggregates. Widespread concern developed over a possible tightening of monetary policy and the consequences for near-term movements of interest rates. Some observers construed Federal Reserve System bill sales before a weekly Treasury bill auction on June 7 to be a confirmation of market expectations. Besides, the increase in the prime lending rate at several banks a week later reinforced the expectations of higher short-term interest rates, and by midmonth there was some discussion about a possible increase in the discount rate. The frequency and size of the Treasury calls on its Tax and Loan Accounts prior to the mid-June corporate income tax collections, moreover, generated apprehension, especially in the bill market, that the Treasury might conduct a larger than expected cash financing in the near future.

Several factors contributed to an improvement in the

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, JUNE 1971

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

Factors	Changes in daily averages— week ended					Net changes
	June 2	June 9	June 16	June 23	June 30	
"Market" factors						
Member bank required reserves	+ 81	+ 169	— 147	+ 274	— 361	+ 16
Operating transactions (subtotal)	— 347	+ 616	+ 51	— 462	— 809	— 951
Federal Reserve float	— 330	+ 324	— 161	+ 315	— 301	— 153
Treasury operations*	+ 169	+ 522	+ 398	— 648	— 776	— 335
Gold and foreign account	—	+ 36	+ 1	— 5	— 11	+ 21
Currency outside banks	— 80	— 251	— 366	— 109	+ 346	— 460
Other Federal Reserve liabilities and capital	— 105	— 16	+ 180	— 15	— 68	— 24
Total "market" factors	— 260	+ 785	— 96	— 188	—1,170	— 935
Direct Federal Reserve credit transactions						
Open market operations (subtotal)	— 74	— 481	— 48	— 56	+1,025	+ 366
Outright holdings:						
Treasury securities	+ 13	— 439	— 463	+ 242	+1,178	+ 531
Bankers' acceptances	+ 2	+ 1	— 1	— 1	—	+ 1
Special certificates	—	+ 94	+ 416	— 510	—	—
Repurchase agreements:						
Treasury securities	— 70	— 73	—	+ 162	— 119	— 100
Bankers' acceptances	— 11	— 37	—	+ 28	— 25	— 45
Federal agency obligations	— 8	— 27	—	+ 23	— 9	— 21
Member bank borrowings	+ 379	— 493	+ 250	+ 215	+ 134	+ 485
Other Federal Reserve assets†	+ 72	— 12	+ 48	+ 48	+ 40	+ 196
Total	+ 377	— 985	+ 249	+ 208	+1,198	+1,047
Excess reserves	+ 111	— 212	+ 165	+ 20	+ 28	+ 112

	Daily average levels					Monthly averages
Member bank:						
Total reserves, including vault cash	30,276	29,907	30,207	29,953	30,342	30,137‡
Required reserves	29,991	29,822	29,969	29,695	30,056	29,907‡
Excess reserves	285	73	238	258	286	228‡
Borrowings	646	153	403	618	752	514‡
Free, or net borrowed (—), reserves	— 361	— 80	— 165	— 360	— 466	— 286‡
Nonborrowed reserves	29,630	29,754	29,804	29,335	29,590	29,623‡
Net carry-over, excess or deficit (—)§	103	171	89	112	106	106‡

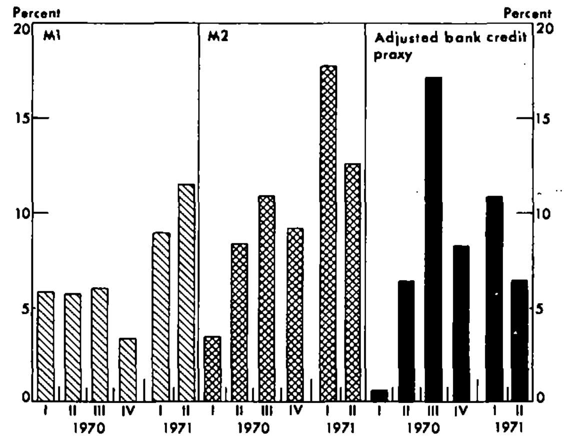
Note: Because of rounding, figures do not necessarily add to totals
* Includes changes in Treasury currency and cash.
† Includes assets denominated in foreign currencies.
‡ Average for five weeks ended June 30.
§ Not reflected in data above.

[1] These figures do not reflect a recent revision in the liabilities to foreign branches series at weekly reporting banks in New York City to include liabilities to branches in United States possessions, territories, Puerto Rico, and overseas military installations. This series also has been revised to include those loans sold to branches outside the United States if the loan sales are subject to the provisions of Regulation M.

Chart II

CHANGES IN MONETARY AND CREDIT AGGREGATES

Seasonally adjusted annual rates of change



Note: Data for 1971-II are preliminary.

M1 = Currency plus adjusted demand deposits held by the public.

M2 = M1 plus commercial bank savings and time deposits held by the public, less negotiable certificates of deposit issued in denominations of $100,000 or more.

Adjusted bank credit proxy = Total member bank deposits subject to reserve requirements plus nondeposit liabilities, such as Euro-dollar borrowings and commercial paper issued by bank holding companies or other affiliates.

Source: Board of Governors of the Federal Reserve System.

market atmosphere at midmonth. On Wednesday, June 16, the Treasury announced plans to raise $4 billion of cash through the auction of $2.25 billion of 6 percent 16½-month notes and $1.75 billion of September tax anticipation bills (TAB's). The Treasury said that these auctions, together with additions of $100 million of bills to each of the regular weekly auctions, were expected to satisfy its cash needs through July. The terms of the offerings met a favorable market reception and encouraged those participants who had expected a larger financing of bills with a longer maturity. In addition, relatively light dealer inventories characterized a good technical position of the Government securities market, and the turnaround in the corporate bond market added further encouragement. The 16½-month notes were auctioned on June 22 at an average yield of 6.00 percent, with tenders accepted at yields as high as 6.05 percent. The TAB's were auctioned on June 30 at an average yield of 5.04 percent.

Against this background, rates on three-month Treasury bills climbed by 78 basis points from June 3 to June 15, peaking out at 5.02 percent. The rise in bill rates was particularly sharp in the second week of June. In the weekly auction on June 14, the average issuing rates on new three- and six-month issues were established at 4.99 percent and 5.20 percent, respectively, both up 48 basis points from the preceding week's auction (see Table II). Rates edged irregularly lower over the next few days, but reversed direction on June 25. Some market participants grew apprehensive over the possibility of the liquidation of large amounts of bills by the German central bank to raise funds for the sizable sales of dollars that it was reportedly making in the foreign exchange market. Bidding proved quite weak in the weekly bill auction on June 28. The average issuing rates on the three- and six-month bills were 5.08 percent and 5.28 percent, respectively, and tenders were accepted over an unusually wide range of prices. Bill rates rose precipitously after the auction, and the three-month bill closed the month at 5.22 percent. Over the month, most bills closed on quotations which were 56 to 120 basis points higher than at the end of May.

Market yields on Treasury coupon securities moved in a pattern similar to the course followed by bill rates. From early June to midmonth, yields on issues due in three to five years rose as sharply as bill rates—up an average of 77 basis points—while the increase in long-term Treasury bond yields amounted to 35 basis points. The rally in the corporate bond market contributed to a significantly better atmosphere in the Treasury coupon market during the third week of June when prices pushed steadily higher. The decline in yields was interrupted, however, as market participants reacted to the large May increase in the consumer price index, announced on June 21, which underscored the fact that inflation still presented a stubborn problem. Thereafter, yields on intermediate-term issues turned upward, rising sharply in the closing days of the month. On balance, yields on these issues increased by 55 to 85 basis points during June. Reflecting the better tone in the corporate bond market, yields on long-term Treasury bonds were steady during the latter part of June and closed below their midmonth levels. Over the month as a whole, however, these yields were 4 to 29 basis points higher.

OTHER SECURITIES MARKETS

The market for corporate bonds displayed widely fluctuating yields in June. For example, yields on major new high-quality utility issues dropped from 8.18 percent on May 26 to 7.73 percent on June 3 and then climbed back to 8.20 percent on June 15. By the end of June, a new high-grade utility issue carried an 8.00 percent return to investors. In the municipal sector, securities prices were steadily eroded after the first few days of June. *The Weekly Bond Buyer's* twenty-bond yield index declined from 5.86 percent at the end of May to 5.70 percent, but backed up sharply to 6.23 percent by June 24, before easing to

6.19 percent at the beginning of July. During June, an estimated $4.8 billion of new corporate and municipal issues came to market, roughly $0.8 billion above the monthly average issued in the record year of 1970. Although no significant decrease in the municipal calendar is sighted, the calendar of future corporate bond issues has lightened considerably.

Among the significant issues during the month, $27 million of Aa-rated utility bonds, marketed on June 3, was very aggressively priced to yield 7.73 percent, 45 basis points below a similarly rated issue sold a week earlier. The bonds sold slowly, and when they were subsequently freed from price restrictions, the yield rose by 20 basis points. On June 10, the sale of a $100 million Aa-rated utility issue underscored the turnaround that had occurred in the corporate sector. The bonds were reoffered to investors with an 8.10 percent yield, which represented an increase of 37 basis points in about five trading days, but the issue met investor resistance. Then, on June 15, underwriters bid aggressively for $60 million of Aaa-rated (by Moody's) utility bonds which were reoffered to yield 8.20 percent, 83 basis points above the last Aaa-rated utility issue marketed in mid-April. Broadly based retail demand quickly absorbed the unusual offer and helped to reverse the week-old slide of bond prices.

The rally halted, however, in the wake of the scattered increase in the prime rate at several banks and the dismal reception accorded a $150 million Bell System offering on June 21. The Aaa-rated issue was aggressively priced to yield 7.80 percent, which was 40 basis points below the yield provided on comparable bonds marketed on May 25. Prices generally retreated in the capital markets following the languid market response to the Bell System bonds. The sharply accelerated rise in the consumer price index in May also depressed market sentiment.

No new utility bonds came to market in the last days of June. The scarce supply fostered fairly active trading, and prices of seasoned issues inched up by as much as ⅜ point. Dealers whittled down their unsold balances of outstanding issues and, after a slow start, a utility issue rated Aa was finally successfully distributed at an 8 percent yield.

In contrast to the behavior of corporate bond yields, yields on tax-exempt securities spiraled steadily upward during June, uninterrupted by the rally that brought relief to both the corporate and Treasury securities markets. Participants expected no near-term relief from the heavy financing calendar, and $1.9 billion of new issues was sold, compared with the $2.2 billion of financing in May. Furthermore, commercial bank buying appeared to slacken as the month progressed, falling below the vigorous pace evidenced earlier in the year. Dealer inventories, as recorded in the Blue List, were relatively low early in June, rose sharply in midmonth, but then receded to $487 million on June 29, the lowest level since July 1970.

Early in June, the calendar included two sizable Aaa-rated state government offerings: $100 million of Illinois anti-pollution bonds and $75 million of New Jersey various-purpose bonds. The Illinois issue was reoffered at yields ranging from 20 to 45 basis points below those on a similar issue marketed on May 20. The issue met a favorable investor reception at these sharply lower yields, which reflected the general improvement in the market as June began and also the scarcity of Illinois bonds. A day later, the New Jersey issue was awarded at yields running about 5 to 15 basis points above the corresponding maturities in the Illinois package. The higher yields were explained largely by the more frequent entry of New Jersey into the market and by the larger volume of the state's outstanding obligations. Despite good buying interest on the part of commercial banks, insurance companies, and other institutions, $28 million of the issue remained unsold at the end of the day.

On Tuesday, June 8, a bellwether New York State issue of $90 million of highway bonds was marketed, and participants hoped that prices in the tax-exempt market would continue the uptrend exhibited in early June. The Aa-rated issue sold slowly, however, but initial sales may have been inhibited by the huge $1.3 billion of New

Table II

AVERAGE ISSUING RATES*
AT REGULAR TREASURY BILL AUCTIONS

In percent

Maturities	Weekly auction dates—June 1971			
	June 7	June 14	June 21	June 28
Three-month	4.510	4.989	4.958	5.080
Six-month	4.720	5.200	5.133	5.277

Maturities	Monthly auction dates—April-June 1971		
	April 27	May 27	June 24
Nine-month	4.402	4.688	5.425
One-year	4.422	4.790	5.567

* 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.

York State notes auctioned the same day. Two weeks later, the managing syndicate released the $25 million unsold balance into the market, and yields rose by 20 to 30 basis points. On June 22, a key issue of $100 million of California various-purpose bonds came to market. Also rated Aa, this issue elicited only a lukewarm response from investors at yields that ranged from 15 to 30 basis points above the returns on corresponding maturities in the New York issue. Market participants had withdrawn to the sidelines, as they pondered the sharp increase in the consumer price index registered during May. Attempting to lure investors back into the market, dealers released several recent issues from syndicate price restrictions. Prices subsequently plunged, raising yields by 25 to 30 basis points.

After prices nosedived to their lowest levels since November 1970, the tax-exempt market stabilized on June 29 when excellent retail demand met two new state bond offerings. The Aa-rated Delaware and Kentucky issues totaled $70 million and carried yields which were 10 to 30 basis points above the returns on comparable securities available about two weeks earlier.