The Money and Bond Markets in February

A deeply cautious tone pervaded the capital markets in February, and prices in both public and private sectors moved sharply lower over the month. Market attention turned increasingly to the substantial current and prospective demands for funds—particularly on the part of corporations and Government agencies—which were converging upon the credit markets. It was widely believed in the market that such demands spelled significant further upward pressures on interest rates.

The money market was consistently firm in February, and member bank borrowings from the Reserve Banks rose moderately. Many banks in the leading money centers were under reserve pressures, but a good availability of excess reserves in the Federal funds market resulted in the smooth accommodation of a large portion of these needs. Treasury bill rates receded in early February, partly reflecting switches out of coupon issues into short-term debt instruments by investors anticipating higher interest rates. Subsequently, however, the cautious atmosphere evident in the capital markets penetrated the bill sector as well, and rates rose irregularly until late in the month when they again edged lower. At the close of the month, a large New York City commercial bank increased the interest rate paid on nonnegotiable savings certificates of deposit of nine months' or longer maturity from 4¾ per cent to 5 per cent.

THE GOVERNMENT SECURITIES MARKET

An extremely hesitant atmosphere descended upon the market for Government notes and bonds in February when several factors revived uncertainties over the viability of prevailing interest rate levels. Predominant among these developments were the prospective heavy demands upon the capital markets which came to light, the large volume of corporate, tax-exempt, and Government agency financing which was completed during the month itself, and the lukewarm response accorded a sizable offering of Export-Import Bank participation certificates. Government agency flotations alone, including large issues of the Federal Land Banks, the Federal Intermediate Credit Banks, the Federal Home Loan Banks, and the Federal National Mortgage Association, tapped the credit markets for over $1 billion, and it appeared likely that such financing, both to refund maturing issues and to obtain new money, would continue at a brisk pace. The market also reacted hesitantly to news that the Federal Housing Administration had raised the maximum permissible interest rate chargeable by lenders on insured mortgages from 5¼ per cent to 5½ per cent. In addition, market participants were influenced by discussions in the press and in market advisory letters of the situation in Vietnam, continuing economic expansion, intensified inflationary pressures, the uncertain prospects for additional fiscal restraint, and the possibility of more restrictive monetary policy.

The announcement early in the month of the unexpectedly large response to the Treasury's February refunding of 1966 issues produced little improvement in the underlying market sentiment. In that refunding, $9.8 billion of the total of $28.8 billion of outstanding notes and bonds eligible for exchange was converted into two new Treasury note issues.[1] Subscriptions for the new 4⅞ per cent notes of August 1967 and the 5 per cent notes of November 1970 aggregated $2.1 billion and $7.7 billion, respectively. Public owners of the eligible outstanding issues converted approximately 83.6 per cent of their holdings of the February 15 and April 1 maturities and 44.8 per cent of their May 15 and August 15 maturities.

Against the backdrop of the widespread expectation of upward pressures on interest rates, prices of most outstanding Treasury notes and bonds declined sharply during February. Expanded offerings of coupon issues arose mainly from professional sources, but also included some investor selling. In the cautious atmosphere which generally prevailed, demand favored the short-term area where a few issues rose in price over the month. The new 5 per cent notes of 1970, in particular, enjoyed a persistent demand. Price declines of as much as 3 points in

[1] For details of the offering, see this *Review* (February 1966), page 43.

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, FEBRUARY 1966

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

Factors	Changes in daily averages—week ended Feb. 2	Feb. 9	Feb. 16	Feb. 23	Net changes
"Market" factors					
Member bank required reserves*	− 44	+ 210	+ 166	+ 97	+ 429
Operating transactions (subtotal)	− 280	− 844	+ 155	+ 482	− 487
Federal Reserve float	− 178	− 236	+ 68	+ 302	− 44
Treasury operations†	− 63	− 33	− 29	+ 234	+ 109
Gold and foreign account	− 35	+ 29	+ 16	+ 6	+ 15
Currency outside banks*	+ 59	− 430	+ 133	+ 65	− 173
Other Federal Reserve accounts (net)‡	− 63	− 173	− 33	− 127	− 396
Total "market" factors	− 324	− 634	+ 321	+ 579	− 58
Direct Federal Reserve credit transactions					
Open market instruments					
Outright holdings:					
Government securities	+ 88	+ 409	− 166	− 318	+ 14
Bankers' acceptances	− 1	− 1	+ 1	+ 1	—
Repurchase agreements:					
Government securities	+ 249	+ 100	− 142	− 287	—
Bankers' acceptances	− 34	+ 4	− 6	− 2	− 38
Member bank borrowings	+ 66	+ 85	− 50	+ 67	+ 168
Other loans, discounts, and advances	− 1	− 1	—	—	− 2
Total	+ 367	+ 656	− 363	− 520	+ 140
Excess reserves*	+ 43	+ 22	− 42	+ 59	+ 82

	Daily average levels				
Member bank:					
Total reserves, including vault cash*	22,538	22,350	22,142	22,104	22,234§
Required reserves*	22,190	21,980	21,814	21,717	21,925§
Excess reserves*	348	370	328	387	358§
Borrowings	418	503	453	520	474§
Free reserves*	− 70	− 133	− 125	− 133	− 115§
Nonborrowed reserves*	22,120	21,847	21,689	21,584	21,810§

	Changes in Wednesday levels				
System Account holdings of Government securities maturing in:					
Less than one year	+ 1,009	+ 10	+ 113	− 230	+ 911
More than one year	—	—	− 957	+ 10	− 947
Total	+ 1,009	+ 10	− 844	− 220	− 36

Note: Because of rounding, figures do not necessarily add to totals.
* These figures are estimated.
† Includes changes in Treasury currency and cash.
‡ Includes assets denominated in foreign currencies.
§ Average for four weeks ended February 23, 1966.

Table II

RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended Feb. 2	Feb. 9	Feb. 16	Feb. 23	Average of four weeks ended Feb. 23
Eight banks in New York City					
Reserve excess or deficiency(−)*	5	15	− 32	21	2
Less borrowings from Reserve Banks	10	142	116	103	93
Less net interbank Federal funds purchases or sales(−)	82	4	96	− 171	3
Gross purchases	*1,180*	*1,048*	*1,194*	*1,003*	*1,106*
Gross sales	*1,099*	*1,044*	*1,098*	*1,174*	*1,104*
Equals net basic reserve surplus or deficit(−)	− 87	− 130	− 244	89	− 93
Net loans to Government securities dealers	693	543	493	310	510
Thirty-eight banks outside New York City					
Reserve excess or deficiency(−)*	14	30	27	16	22
Less borrowings from Reserve Banks	81	87	72	119	90
Less net interbank Federal funds purchases or sales(−)	686	837	694	639	714
Gross purchases	*1,519*	*1,455*	*1,460*	*1,561*	*1,499*
Gross sales	*833*	*617*	*767*	*922*	*785*
Equals net basic reserve surplus or deficit(−)	− 753	− 894	− 738	− 742	− 782
Net loans to Government securities dealers	278	168	184	73	176

Note: Because of rounding, figures do not necessarily add to totals.
* Reserves held after all adjustments applicable to the reporting period less required reserves and carry-over reserve deficiencies.

Table III

AVERAGE ISSUING RATES* AT REGULAR TREASURY BILL AUCTIONS

In per cent

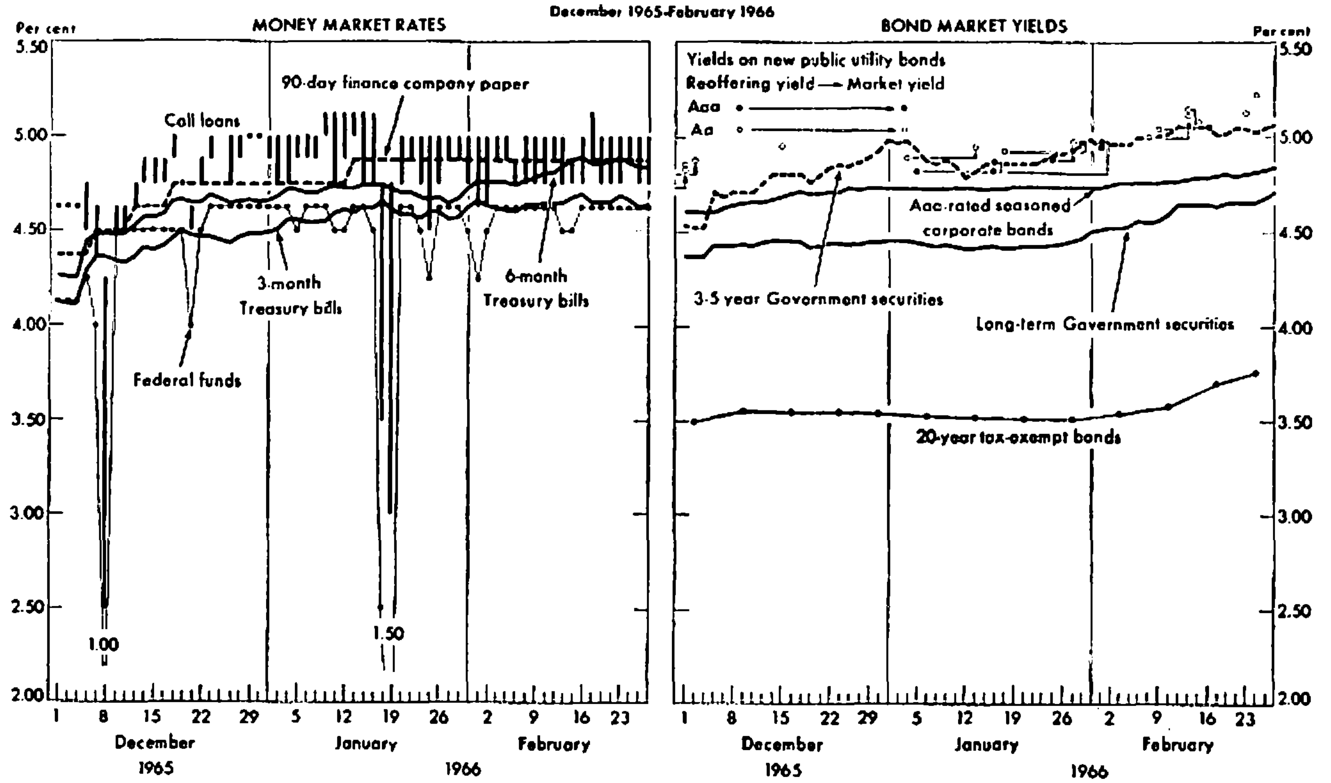
Maturities	Weekly auction dates—Feb. 1966: Feb. 7	Feb. 14	Feb. 21	Feb. 28
Three-month	4.650	4.695	4.696	4.661
Six-month	4.774	4.876	4.892	4.861

Maturities	Monthly auction dates—Dec. 1965-Feb. 1966: Dec. 23	Jan. 25	Feb. 23
One-year	4.731	4.699	4.945

* 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.

SELECTED INTEREST RATES*

December 1965-February 1966



Note: Data are shown for business days only.

* MONEY MARKET RATES QUOTED: Daily range of rates posted by major New York City banks on new call loans (in Federal funds) secured by United States Government securities (a point indicates the absence of any range); 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- and six-month Treasury bills.

BOND MARKET YIELDS QUOTED: Yields of new Aaa- and Aa-rated public utility bonds are plotted around a line showing daily average yields of seasoned Aaa-rated corporate bonds (arrows point from underwriting syndicate reoffering yield of a given issue to market yield of the same issue immediately after it has been released from syndicate restrictions); daily averages of yields of long-term Government securities (bonds due or callable in ten years or more) and of Government securities due in three to five years, computed on the basis of closing bid prices; Thursday averages of yields of 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.

the longer maturities, however, left yields on long-term Government bonds at their highest levels in more than forty years. (The right-hand panel of the chart illustrates the recent rise in yields.) After midmonth, demand from official and investment sources triggered some professional short covering and prices of coupon issues improved. The rally was of short duration, however, and a very heavy tone reappeared in the latter part of the month when aggressive professional offerings and investment selling once again drove prices considerably lower.

In contrast to the weakness evident in the coupon sector, a steadier tone prevailed in the Treasury bill market in the first third of the month. During this period, bill rates edged irregularly lower (see left-hand panel of the chart) on fairly active demand favoring the shorter maturities. The interest in bills partially reflected switching out of coupon issues, as well as temporary purchases of short-term obligations by investors postponing commitments in the bond markets. Gradually, concern over the interest rate outlook also became more prominent in the bill sector. Bill rates generally rose from February 10 through February 16 as the underlying uncertainty prompted aggressive professional offerings. At the higher rate levels that emerged, a moderate demand for short-dated bills persisted, including demand from state and municipal bodies, and rates receded at times. Although the affinity of investors for short-term debt instruments in periods of deep uncertainty continued to provide some reinforcement to the bill market, a hesitant undertone dominated the sector, and as the March dividend and tax dates drew nearer, Government securities dealers became more cautious. Late in the month, however, bill rates declined slightly when demand arising from the temporary investment of the proceeds of recent securities issues and from sources deferring bond investments depleted market supplies. At the close of the month, the newest outstanding three-month bill was bid at 4.64 per cent, 1 basis point above the comparable rate quoted on January 31.

OTHER SECURITIES MARKETS

As in the Government securities market, prices of corporate and tax-exempt bonds moved lower through most of the month while investors weighed the impact on interest rates of current and prospective heavy demands for new capital. The tax-exempt sector was besieged, in addition, by continuing reports of selling by commercial banks. New corporate and tax-exempt bonds which were publicly floated in February totaled approximately $550 million and $745 million, respectively. They were marketed at progressively higher yields but were nevertheless accorded mixed receptions. (In addition, a substantial volume of corporate bonds was privately placed in February.) Among the major new corporate offerings, all the issues that were received favorably during the month carried special protection against early refunding. Dealers made some headway in paring their inventories of older bonds, although only after offering sizable price concessions. As the month drew to a close, all signposts seemed to point to the maintenance of market pressures, since a steady stream of announcements raised the March calendar of prospective public offerings to about $¾ billion in the corporate sector and $1 billion in the tax-exempt sector.

Over the month as a whole, the average yield on Moody's seasoned Aaa-rated corporate bonds rose by 10 basis points to 4.84 per cent, while *The Weekly Bond Buyer's* series for twenty seasoned tax-exempt issues (carrying ratings ranging from Aaa to Baa) climbed by 25 basis points to 3.76 per cent (see the right-hand panel of the chart). At the same time the average yield on new corporate bonds, adjusted to an Aaa basis, also rose by 25 basis points to 5.10 per cent. All these indexes are, however, based on only a limited number of issues and do not necessarily reflect market movements fully.

THE MONEY MARKET AND BANK RESERVES

The money market displayed a firm tone during February, but no unusual pressures developed. The major money market banks as a whole remained in a relatively deep, though diminishing, basic reserve deficit. These banks bought large amounts of Federal funds—chiefly at the "premium" rate[2] of 4⅝ per cent—from a few New York City banks which had substantial basic reserve surpluses as well as from "country" banks. The residual reserve needs of the deficit banks were filled through moderately greater borrowings from the Federal Reserve than had occurred in January. As the month progressed, nationwide reserve availability contracted somewhat, and average net borrowed reserves returned to a level more closely in line with the levels which had prevailed in early autumn.

Rates posted by the major New York City banks on their call loans to Government securities dealers ranged from 5 per cent to as low as 4¾ per cent on most days. Early in the period, dealers in bankers' acceptances increased most of their rates by ⅛ of a per cent, making the rate on ninety-day unendorsed acceptances 5 per cent (bid). At the close of the month, commercial paper dealers also raised their rates by ⅛ of a per cent, setting the offering rate on prime four- to six-month paper at 5 per cent. In addition, the offering rates posted by many of the large New York City banks on negotiable time certificates of deposit were adjusted progressively higher with rates on new three- and six-month and one-year certificates rising by about 10, 12, and 25 basis points, respectively, during the month. Despite these more attractive rates, the volume of negotiable time certificates of deposit outstanding at weekly reporting banks in New York City declined by more than $350 million in the four weeks ended February 23, in contrast to an increase of about $275 million in such deposits during the corresponding period last year.

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[2] I.e., above the 4½ per cent Federal Reserve discount rate.