The Money and Bond Markets in May

The money market was generally quite firm in May, although there was some variation in the intensity of market pressures within individual statement weeks. Member bank reserve positions remained under considerable pressure during the month, as the credit demands of the economy continued to push against shrinking nationwide reserve availability. Member bank borrowings from the Federal Reserve Banks were substantial, and most trading in Federal funds took place in a 4⅞ to 5⅛ per cent range, marking the first time the effective rate on Federal funds has been as much as ⅝ of a per cent above the discount rate. Indeed some trading occurred at a record high of 5¼ per cent, ¾ per cent above the discount rate.

In the Treasury bill market, a fairly good overall demand emerged during the first half of the month. However, investor interest in bills concentrated in the short maturity area where rates declined, while rates for longer bills edged higher. Subsequently, demand for bills persisted, but firmer conditions in the money market made dealers quite cautious and bill rates fluctuated narrowly over the remainder of the month.

Prices of Treasury notes and bonds moved irregularly through mid-May with prices of most issues showing a net increase. Crosscurrents in market sentiment were evident as traders reacted to the continuing public debate over the likelihood of an anti-inflationary tax increase and to various other developments. In particular, the coupon sector was affected by news of a contraction in automobile production, which had a depressing effect on stock prices. Against this background, investment demand for coupon issues remained rather light and trading was dominated by professional participants. In the second half of the month, prices of coupon issues drifted lower in reaction to the widespread view that prospects for a tax increase were dimming, to uncertainties over the future posture of monetary policy, and to indications that pressures were mounting in other sectors of the bond market.

In the corporate and tax-exempt sectors, traders focused their attention in May upon the heavy flow of current and scheduled flotations. Offering yields on new issues climbed to record levels, while the termination of syndicate price restrictions also led to a series of subsequent dealer price concessions, particularly in the corporate area. Nevertheless investor demand remained restrained and selective throughout the month.

THE MONEY MARKET AND BANK RESERVES

The firmer tone which had developed in the money market during April intensified in May. Rates on a variety of short-term money market instruments—including bankers' acceptances, commercial paper placed by dealers, and directly placed finance company paper—were increased from ⅛ to ⅜ of a per cent, while rates posted by commercial banks on call loans to Government securities dealers generally were about ¼ of a per cent higher than in April. At the same time, Federal funds traded mainly in a 4⅞ to 5⅛ per cent range.

Several money market banks posted higher offering rates during May on time certificates of deposit maturing in three months or more. Toward the end of the month, a few banks reportedly were paying the maximum permissible rate of 5½ per cent on certificates maturing in three months, while the ceiling rate was quite commonly applied to longer maturities. To some extent, the higher rates were aimed at attracting funds to replace the approximately \$1.1 billion of certificates reaching maturity at the weekly reporting member banks during the month, as well as the additional \$3.9 billion maturing in June when corporate dividend and tax payments come due. Partly as a result of the more attractive yields, the weekly reporting member banks were able to increase their time certificates outstanding by about \$295 million in May.

As the credit needs of the economy pressed against a contracting availability of bank reserves, member banks were under reserve pressure. They responded to this pressure by making purchases of Federal funds at rising rates, and by recourse to the Federal Reserve "discount window" where borrowings averaged \$653 million (see Table I).

Intraweekly patterns of variation in market pressures, which had also been evident in April, were superimposed on the underlying May trend toward more stringent money market conditions. During the statement week ended May

Table I

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

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

Factors	Changes in daily averages—week ended May 4	May 11	May 18	May 25	Net changes
"Market" factors					
Member bank required reserves*	— 214	+ 196	+ 101	+ 223	+ 306
Operating transactions (subtotal)	— 246	— 564	+ 178	— 323	— 955
Federal Reserve float	— 60	— 151	+ 248	— 42	— 5
Treasury operations†	— 18	+ 13	— 85	— 259	— 349
Gold and foreign account	— 23	+ 11	— 92	+ 7	— 97
Currency outside banks*	— 184	— 454	+ 124	+ 163	— 351
Other Federal Reserve accounts (net)‡	+ 41	+ 15	— 18	— 195	— 157
Total "market" factors	— 460	— 368	+ 279	— 100	— 649
Direct Federal Reserve credit transactions					
Open market instruments					
Outright holdings:					
Government securities	+ 309	+ 185	— 128	+ 203	+ 569
Bankers' acceptances	+ 3	—	—	+ 1	+ 4
Repurchase agreements:					
Government securities	+ 82	+ 217	— 164	— 135	—
Bankers' acceptances	—	— 43	—	+ 40	— 3
Member bank borrowings	— 26	+ 63	— 17	— 10	+ 11
Other loans, discounts, and advances	— 4	+ 2	—	— 1	— 3
Total	+ 366	+ 422	— 308	+ 98	+ 578
Excess reserves*	— 94	+ 54	— 29	— 2	— 71
	Daily average levels				
Member bank:					
Total reserves, including vault cash*	22,735	22,593	22,463	22,238	22,507§
Required reserves*	22,449	22,253	22,162	21,929	22,196§
Excess reserves*	286	340	311	309	311§
Borrowings	617	680	663	653	653§
Free reserves*	— 331	— 340	— 352	— 344	— 342§
Nonborrowed reserves*	22,118	21,913	21,800	21,585	21,854§
	Changes in Wednesday levels				
System Account holdings of Government securities maturing in:					
Less than one year	+ 559	— 270	— 483	+ 250	+ 56
More than one year	—	—	+ 282	—	+ 282
Total	+ 559	— 270	— 201	+ 250	+ 338

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 May 25.

Table II

RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS MAY 1966

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended May 4	May 11	May 18	May 25	Average of four weeks ended May 25
Eight banks in New York City					
Reserve excess or deficiency(—)*	7	29	7	7	13
Less borrowings from Reserve Banks	115	82	69	13	70
Less net interbank Federal funds purchases or sales(—)	179	565	348	— 19	268
Gross purchases	*985*	*1,029*	*927*	*834*	*944*
Gross sales	*806*	*463*	*578*	*853*	*675*
Equals net basic reserve surplus or deficit(—)	— 287	— 619	— 410	13	— 326
Net loans to Government securities dealers	980	699	629	520	707
Thirty-eight banks outside New York City					
Reserve excess or deficiency(—)*	38	23	19	37	29
Less borrowings from Reserve Banks	67	126	135	18	87
Less net interbank Federal funds purchases or sales(—)	174	290	357	280	275
Gross purchases	*1,231*	*1,131*	*1,160*	*1,194*	*1,179*
Gross sales	*1,057*	*842*	*803*	*914*	*904*
Equals net basic reserve surplus or deficit(—)	— 203	— 393	— 473	— 261	— 333
Net loans to Government securities dealers	478	387	324	276	366

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—May 1966: May 2	May 9	May 16	May 23	May 27
Three-month	4.674	4.630	4.626	4.638	4.641
Six-month	4.782	4.818	4.823	4.835	4.826

Maturities	Monthly auction dates—March-May 1966: March 24	April 26	May 25
One-year	4.739	4.773	4.966

* 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.

4 and to a lesser extent during the May 18 period—in both cases the first half of a biweekly reserve averaging period for "country" banks—net nationwide reserve availability was relatively abundant before the weekend when, in addition, reserves tended to be concentrated in the money center banks. Consequently, as some city banks built up basic reserve surpluses and others were able to fill a good portion of their reserve needs in the Federal funds market, member bank borrowings from the Federal Reserve were relatively moderate over the weekend. Following the April 30-May 1 and May 14-15 weekends, nationwide reserve availability contracted while the distribution of reserves shifted in favor of the country banks. City banks moved into deep basic reserve deficits and, with Federal funds in less abundant supply, borrowings from the Federal Reserve Banks rose sharply. Such borrowings amounted to $889 million on Wednesday, May 4, and $901 million on Wednesday, May 18.

A contrasting intraweekly pattern was evident in the money market during the statement periods ended May 11 and May 25, each of which represented the concluding half of a country bank reserve averaging period. As these weeks began, reserves were lodged outside the money centers, while the city banks cautiously managed their reserve positions in the wake of the taut money market conditions which they had encountered on May 4 and May 18. Thus banks with basic reserve surpluses held on to their reserves rather than place them in the Federal funds market over the weekend, while deficit banks bid strongly for funds at rates as high as 5¼ per cent, and then turned to the Federal Reserve discount window to fill their residual reserve needs. Accordingly, borrowings from the Federal Reserve were substantial over both the May 7-8 and May 21-22 weekends. Following these weekends, the excess reserves which had been accumulated earlier, partly as a result of the heavy pre-weekend borrowings, spilled into the money market. Consequently, some of the tension faded from the money market toward the end of the May 11 and May 25 statement periods, Federal funds traded occasionally below the discount rate, and member bank borrowings from the Federal Reserve tapered off.

THE GOVERNMENT SECURITIES MARKET

In the market for Treasury coupon issues, prices edged irregularly higher through mid-May. Investors generally remained on the sidelines assessing a number of unfolding events, and activity was largely of a professional nature. During much of this period, the bond market was alternately strengthened and depressed by conflicting opinions on the likelihood of a Federal tax increase. Moreover, when the early May news of cutbacks in automobile production triggered a prolonged downward spiral in stock prices, the price behavior of Treasury coupon-bearing obligations became quite sensitive to the daily trend of stock prices. In broad terms, setbacks in the equities market generally buoyed bond prices during the first half of May, as dealers in Government coupon issues covered short positions when stock prices fell.

With their attention occupied by other matters, bond market participants showed little reaction when the Treasury reported on May 6 that investor response to its May refinancing had been quite restrained.[1] Approximately 43 per cent of the eligible maturing securities held by the public were not exchanged, the largest attrition percentage in any modern refunding.[2] While market observers had generally anticipated that the attrition would be much greater than usual, the actual net redemption exceeded most expectations. The Treasury announced, however, that the results would not cause any alteration in its financing plans.

After midmonth, several factors began to have a restraining effect on the market for Treasury notes and bonds. The coupon sector reacted with caution to a growing consensus that a near-term increase in tax rates was not likely, as well as to news that nationwide reserve availability had contracted further. In addition, traders focused their attention upon the sizable current and prospective demands for funds converging upon the corporate and tax-exempt bond markets and upon the market for Government agency issues. The coupon sector also was affected by the steadier tone emerging in the stock market, and by the Treasury Secretary's suggestion that Congress might consider some modification in the current 4¼ per cent coupon interest rate ceiling on Government bonds. Against this background, prices of intermediate- and long-term Treasury issues moved lower from May 18 until the final day of the month when prices edged higher in response to some professional short covering. (The right-hand panel of the chart on page 142 illustrates the irregular rise in yields which accompanied this decline in prices.)

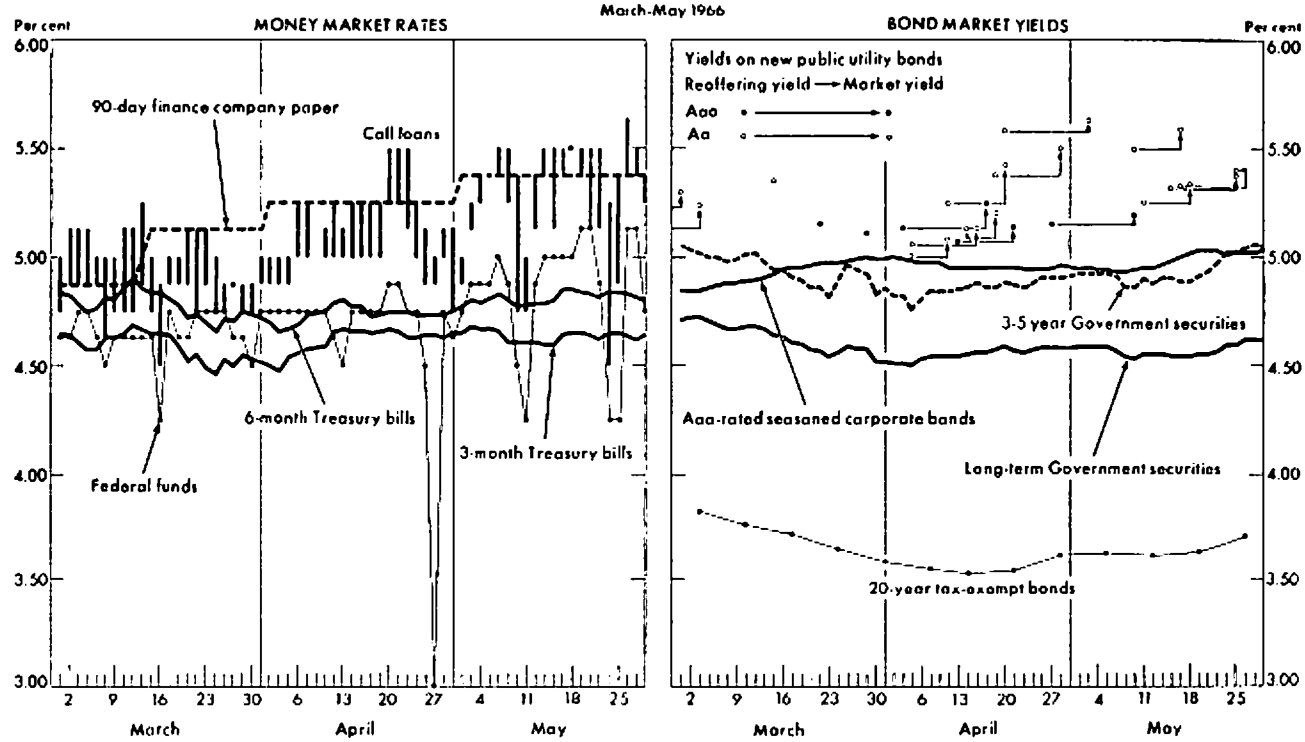
The Treasury bill market displayed a fairly strong tone in May. As was the case in April, a steady demand for

[1] For details of the offering, see this *Review* (May 1966), page 112.

[2] A total of $8.1 billion of the $9.3 billion of notes and bonds maturing on May 15 was converted into the new 4⅞ per cent notes of November 1967 offered in the refunding. However, $6.7 billion of this amount was exchanged by Federal Reserve Banks and Government accounts.

SELECTED INTEREST RATES*

March-May 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 on new Aaa- and Aa-rated public utility bonds are plotted around a line showing daily average yields on seasoned Aaa-rated corporate 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 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 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.

bills from public funds and other sources prevailed during the first half of the month. In addition, a portion of the proceeds of a sizable secondary offering of common stock was reinvested in bills during the period, and bills were also in demand from owners of maturing notes and bonds who had decided not to exchange their holdings for the Treasury's refunding offering. Demand focused on short-dated bills, and rates for issues maturing within three months declined through midmonth. At the same time, rates for longer bill maturities, which were somewhat neglected by investors, generally edged higher (see the left-hand panel of the chart). As a result of the diverse rate movements recorded by bills at different points in the maturity scale, the rate spread between three- and six-month bills widened from 10 basis points in late April to 20 basis points in mid-May. Subsequently, investment demand remained fairly strong, but with money market conditions rather firm, dealers became more aggressive sellers and rates for bills of all maturities fluctuated narrowly.

The market for securities issued by agencies of the United States Government remained quite active in May. A flood of agency flotations reached the market during the month, including offerings by the Federal National Mortgage Association, the Export-Import Bank, the Federal Home Loan Banks, and the Federal Intermediate Credit Banks. Such offerings totaled approximately $2.4 billion in May, of which a substantial $1.4 billion represented new money. During most of the month, investors continued to be quite selective in their response to agency issues as they awaited the heavy calendar of scheduled offerings in this sector. On May 18, an offering by the Federal Home Loan Banks of $656 million of 5.55 per cent eleven-month notes encountered considerable investor resistance. Two days later, however, investors responded enthusiastically to a $312 million par offering by the Federal Intermediate Credit Banks of nine-month debentures carrying a 5.60 per cent coupon rate. Toward the end of May, another large addition to the calendar of scheduled agency issues was made when the Federal National Mortgage Association announced a June offering of $530 million of participation certificates in its pooled loans. The sale will take place under provisions of enabling legislation recently passed by Congress.

OTHER SECURITIES MARKETS

In the markets for corporate and tax-exempt bonds, prices moved steadily lower over most of the month. Demand was quite restrained, as investors evaluated both the performance of new flotations reaching the market and the continuing buildup in the calendar of scheduled offerings. Although new corporate bond offerings totaled a relatively light $385 million in May (estimated), the volume of scheduled flotations grew steadily larger during the month. By the end of May, the four-week calendar of scheduled corporate bond offerings had swollen to approximately $695 million. In the tax-exempt sector, new bonds marketed in May totaled a substantial $845 million (estimated), while a comparable volume awaited flotation in June. With customers rather reluctant to invest their funds in new issues even at record high reoffering yields, underwriters removed syndicate price restrictions on several recent corporate and tax-exempt flotations during the month and adjusted their yields still higher, with the largest concessions occurring in the corporate sector. (As is apparent in the right-hand panel of the chart, yields on new public utility bonds were adjusted higher throughout the month.) Even at the more attractive emerging yield levels, however, investor demand remained quite selective throughout the period both for new and recent issues.

Over the month as a whole, the average yield on Moody's seasoned Aaa-rated corporate bonds rose by 9 basis points to 5.04 per cent, while *The Weekly Bond Buyer's* series for twenty seasoned tax-exempt issues (carrying ratings ranging from Aaa to Baa) rose by 10 basis points to 3.72 per cent (see the right-hand panel of the chart). These indexes are, however, based on only a limited number of seasoned issues and do not necessarily reflect market movements fully, particularly in the case of new and recent issues.