The Money and Bond Markets in December

The improved tone that had emerged in the money and bond markets in November strengthened further in December when the conviction spread among market participants that monetary policy was moving in a somewhat less restrictive direction. Some indications that the pace of economic expansion might be slowing also bolstered market hopes that credit demands would eventually relax and that the apparent shift in monetary policy would be prolonged. In this setting, observers became quite optimistic about the outlook for lower interest rates, and almost every market development during the month was interpreted in a way that reinforced this optimism. Toward the end of the period, the money and bond markets took further encouragement from the announcement that, due to changed circumstances, the special factors referred to in the Federal Reserve System's September 1 policy statement on business loans and discount administration were no longer applicable.[1]

In the market for Treasury obligations, a very strong and broadly based demand for all maturities prevailed during the month. A lively professional demand developed as dealers entered the market to replenish their inventories, especially since funds were readily available to finance their positions. At the same time, investment demand was quite spirited. Against this background, prices of Treasury notes and bonds advanced sharply, rising by as much as 3¾ points in December. The three-month Treasury bill rate declined to as low as 4.78 per cent, its lowest level since early August, and sharply below the 5.59 per cent level to which it had climbed in September. In the corporate and tax-exempt bond sectors, where a large volume of new issues reached the market in December, keen investor buying interest developed and prices of most new and seasoned bonds rose steadily.

The money market displayed a generally comfortable tone during the month. In this environment, the churning associated with the quarterly corporate dividend and tax payments was accommodated without strain. Thus, most Federal funds trading occurred in a 5 to 5½ per cent range during the month, compared with the 5½ to 6 per cent rate range which had predominated in November, and by the end of December several other short-term money market rates were below their late November levels. Both net borrowed reserves and member bank borrowings from the Federal Reserve Banks also declined somewhat on average during the month. Total bank credit expanded at a fairly rapid pace in December, after a sluggish performance in the autumn.

THE GOVERNMENT SECURITIES MARKET

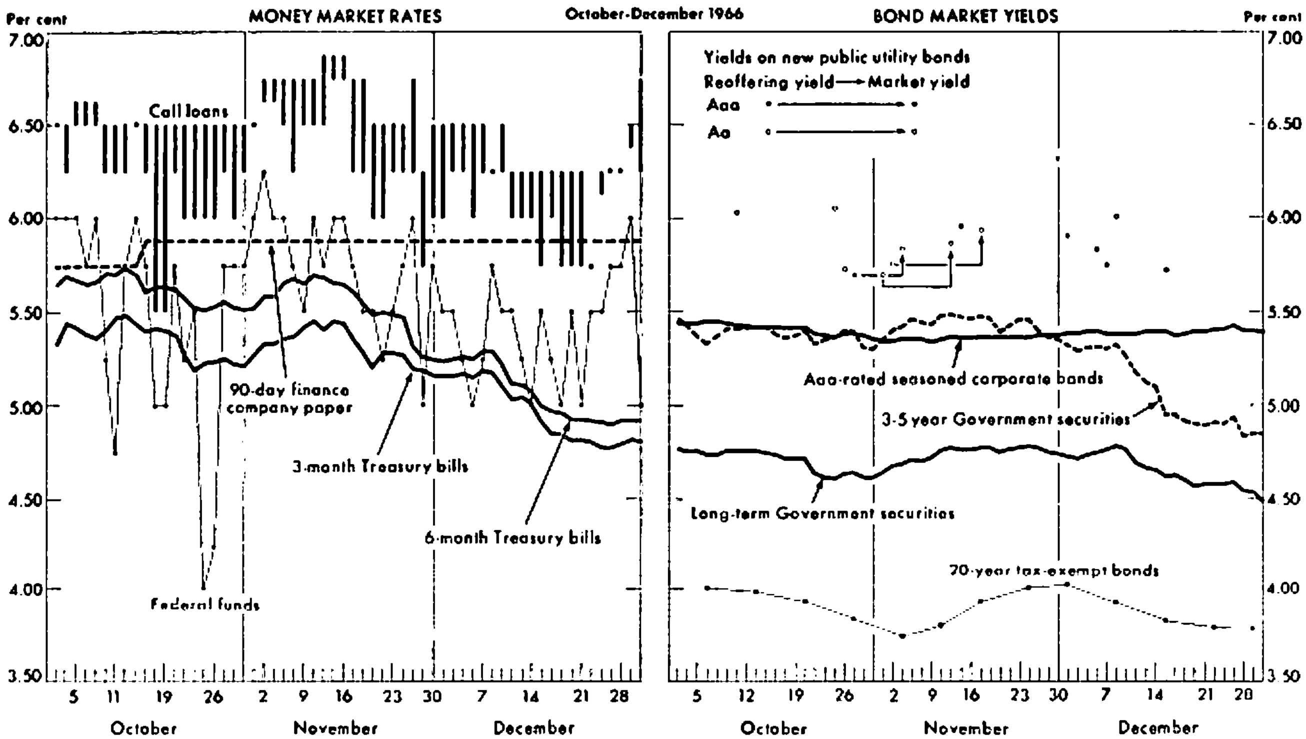
After having declined sharply in late November, Treasury bill rates fluctuated narrowly in early December and then resumed their downward trend. Early in the month, investment demand temporarily slackened somewhat at the lower prevailing yield levels, and offerings from professional sources increased. During this period, dealers cautiously awaited the approaching quarterly corporate dividend and tax payment period, when a large portion of their repurchase agreements with corporations would mature and market supplies of bills would increase. On balance, however, dealers remained fairly optimistic about the general outlook in the bill sector. Consequently, bidding was quite aggressive at the December 6 auction of $800 million of additional June tax anticipation bills, which were sold at an average issuing rate of 5.246 per cent.[2]

Subsequently, the tone of the bill market again strengthened markedly. Demand from a broad spectrum of investors—including public funds, corporations, and commercial banks—expanded sharply, stimulating lively professional demand as well. Both the heavy corporate dividend payments over the December 9-12 period and the

[1] For the full text of the September 1 policy statement, see this *Review* (September 1966), page 209.

[2] For the details of the offering, see this *Review* (December 1966), page 267.

SELECTED INTEREST RATES*



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.

midmonth quarterly corporate tax date passed without giving rise to any real pressure in the bill market, and dealers were able to refinance with little difficulty the bills returned to them when a large volume of corporate repurchase agreements matured. The underlying tone of the bill market became progressively more bullish through most of the month, and very aggressive bidding took place at most of the bill auctions. In the last half of the month, commercial bank demand for Treasury bills expanded considerably when banks actively added bills to their portfolios in preparation for the publication of their year-end statements. Against this background, bill rates declined steeply from December 9 until late in the month, when they fluctuated narrowly. (See the left-hand panel of the chart.) At the regular monthly auction of new nine- and twelve-month bills on December 27, average issuing rates were set at 4.920 per cent and 4.820 per cent, respectively, some 63 and 70 basis points below average rates set a month earlier (see Table III on page 8). At the final regular weekly auction of the month on December 30, average issuing rates were set at 4.822 per cent and 4.911 per cent, respectively, 38 and 43 basis points below average rates at the comparable auction a month earlier.

In the market for Treasury notes and bonds, the more confident undertone that had emerged in November carried over into early December. To be sure, the coupon sector was somewhat restrained at the beginning of the month by the prospect of the very large volume of new corporate and tax-exempt bonds scheduled for sale in December, by talk that the sale of participation certificates might soon be resumed, and by the continuing uncertainty surrounding the outlook for Federal fiscal action. Activity was dominated by sizable year-end switching transactions by commercial banks and other investors. Prices moved irregularly, with some gains recorded by high-coupon issues maturing in five to ten years, which were in strong demand during the first statement week of the month. During the same period, offerings of longer term coupon issues expanded, partly reflecting sales by investors switching into new corporate bonds.

Around December 9, a very strong tone began to appear in all sectors of the coupon market. Sentiment was buoyed by the growing belief that monetary policy was in the process of shifting toward a posture of somewhat less credit restraint. Some market observers also felt that the rate of domestic economic expansion might be slowing, which might portend an easing of credit demands. In addition, the coupon sector was very much encouraged by the good investor receptions being accorded the heavy December volume of new corporate and tax-exempt bonds, even at their rising price levels. Against this background, an aggressive professional demand developed as dealers eagerly attempted to add to their inventories. A strong investment demand for many issues of Treasury notes and bonds also arose from commercial banks, mutual funds, corporations, and public funds, and substantial switching activity for tax purposes persisted. At the same time, market participants seemed to be optimistically awaiting an expected Treasury announcement that the sale of participation certificates would soon be resumed. Indeed, when this announcement was actually made on December 19, market sentiment became even more buoyant, and dealers reported that customers were showing strong interest in the forthcoming certificates. In this setting, prices of notes and bonds generally surged higher throughout the maturity spectrum from December 9 through the end of the month. (The right-hand panel of the chart illustrates the decline in yields which accompanied the rise in prices.) Late in December, some profit taking occurred and prices occasionally edged slightly lower. These setbacks were short-lived, however, and market sentiment quickly recovered. At the close of December, yields on three- to five-year coupon issues were at, or close to, their lows of the year, and more than 1 full percentage point below their midsummer peaks. At the end of the year, yields on long-term issues were also close to their 1966 lows and roughly 45 basis points below their August highs.

A buoyant atmosphere also emerged in the market for Government agency issues in December, when demand from commercial banks and others expanded, and prices generally advanced. New offerings during the month totaled approximately $750 million and were accorded good receptions. In December, the Federal Reserve Bank of New York, acting for the first time under authority recently granted, purchased Government agency issues under repurchase agreements with securities dealers. On December 19, it was announced that the Federal National Mortgage Association would on January 5 sell $1.1 billion of participation certificates, of which $600 million would be publicly offered—less than had generally been expected by the market—and $500 million would be placed directly with Treasury trust accounts. The public offerings included $150 million of five-year maturities, $150 million of ten-year maturities, and $300 million of fifteen-year maturities—considerably less than the amount anticipated in this maturity area. Market reaction to the announcement was quite enthusiastic. When considerable stress developed in the capital markets during the summer, offerings of participation certificates were temporarily suspended. Thus, the January sale of participation certificates represented the first since June.

OTHER SECURITIES MARKETS

The markets for corporate and tax-exempt bonds opened the month anticipating a heavy supply of new flotations in December. Market sentiment soon became quite confident, however, that the offerings could be digested without great difficulty. Subsequently, investors bid aggressively for all of the new securities and prices of most issues rose steadily during the month. As was the case in the Government securities market, the corporate and tax-exempt bond sectors drew encouragement from the view that monetary policy might be shifting toward somewhat less restraint, and that a possible slowdown in the rate of economic growth might ease demand pressures in the credit markets. In the corporate sector, underwriters bid quite aggressively for the new bonds which reached the market in December and, even at resulting lower reoffering yields, readily placed the new securities with investors. In subsequent trading, many of these issues quickly moved to premium prices. Demand for tax-exempt bonds from commercial banks and other sources also expanded in December, and investors generally accorded the substantial volume of new offerings fairly good receptions. However, a more restrained tone prevailed in the tax-exempt sector than was evident in the corporate sector during the period.

Over the month as a whole, the average yield on Moody's seasoned Aaa-rated corporate bonds rose slightly by 2 basis points to 5.39 per cent. *The Weekly Bond*

Table I

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

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

Factors	Changes in daily averages—week ended Dec. 7	Dec. 14	Dec. 21	Dec. 28	Net changes
"Market" factors					
Member bank required reserves*	−227	+4	−685	−42	−950
Operating transactions (subtotal)	−108	+326	+601	−253	+565
Federal Reserve float	+112	+18	+639	+106	+875
Treasury operations†	+116	+345	−57	−146	+257
Gold and foreign account	−72	−19	+26	+2	−63
Currency outside banks*	−289	−214	−35	−186	−724
Other Federal Reserve accounts (net)‡	+26	+195	+27	−29	+219
Total "market" factors	−335	+329	−84	−295	−385
Direct Federal Reserve credit transactions					
Open market instruments					
Outright holdings:					
Government securities	+141	−120	−66	+137	+92
Bankers' acceptances	+4	+5	+6	+2	+17
Special certificates	—	+72	−72	—	—
Repurchase agreements:					
Government securities	+115	−154	+26	+315	+302
Bankers' acceptances	+15	−27	+44	+22	+54
Federal agency obligations	+9	+7	+7	+3	+26
Member bank borrowings	−197	+198	−175	+76	−98
Other loans, discounts, and advances	−1	+6	−8	−2	−5
Total	+96	−10	−238	+554	+402
Excess reserves*	−239	+319	−322	+259	+17
	Daily average levels				
Member bank:					
Total reserves, including vault cash*	23,197	23,512	23,875	24,176	23,690§
Required reserves*	22,998	22,994	23,679	23,721	23,348§
Excess reserves*	199	518	196	455	342§
Borrowings	449	647	472	548	529§
Free reserves*	−250	−129	−276	−93	−187§
Nonborrowed reserves*	22,748	22,865	23,403	23,628	23,161§
	Changes in Wednesday levels				
System Account holdings of Government securities maturing in:					
Less than one year	−208	−143	+374	+31	+54
More than one year	—	—	+8	+12	+20
Total	−208	−143	+382	+43	+74

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 December 28.

Table II

RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS DECEMBER 1966

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended Dec. 7	Dec. 14	Dec. 21	Dec. 28	Average of four weeks ended Dec. 28
Eight banks in New York City					
Reserve excess or deficiency(−)*	20	31	36	17	26
Less borrowings from Reserve Banks	—	121	75	183	95
Less net interbank Federal funds purchases or sales(−)	455	319	586	735	524
Gross purchases	*1,261*	*1,390*	*1,527*	*1,520*	*1,425*
Gross sales	*806*	*1,071*	*941*	*786*	*901*
Equals net basic reserve surplus or deficit(−)	−434	−410	−626	−901	−593
Net loans to Government securities dealers	294	440	688	869	573
Thirty-eight banks outside New York City					
Reserve excess or deficiency(−)*	10	14	41	231	74
Less borrowings from Reserve Banks	85	237	148	130	150
Less net interbank Federal funds purchases or sales(−)	776	1,130	1,413	774	1,023
Gross purchases	*1,773*	*1,773*	*1,986*	*1,597*	*1,782*
Gross sales	*997*	*642*	*573*	*823*	*759*
Equals net basic reserve surplus or deficit(−)	−852	−1,353	−1,521	−674	−1,100
Net loans to Government securities dealers	234	329	394	242	300

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—December 1966: Dec. 5	Dec. 12	Dec. 16	Dec. 23	Dec. 30
Three-month	5.198	5.048	4.842	4.747	4.822
Six-month	5.281	5.129	4.939	4.856	4.911

Maturities	Monthly auction dates—October-December 1966: October 25	November 23	December 27
Nine-month	5.567	5.552	4.920
One-year	5.544	5.519	4.820

* 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.

Buyer's series for twenty seasoned tax-exempt issues, carrying ratings ranging from Aaa to Baa, declined by 23 basis points to 3.77 per cent, considerably below the 4.24 per cent peak reached in late August (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.

THE MONEY MARKET AND BANK RESERVES

A relatively comfortable tone prevailed in the money market in December. Federal funds traded mainly in a 5 to 5½ per cent range, somewhat below the 5½ to 6 per cent range which had predominated in November (see the left-hand panel of the chart). From December 21 through December 23, dealers in bankers' acceptances reduced their rates by ⅛ of a percentage point, making the rate on ninety-day unendorsed acceptances 5⅝ per cent (bid). Both the average level of net borrowed reserves of all member banks and average member bank borrowings from the Federal Reserve Banks contracted moderately from the month before (see Table I).

A substantial volume of funds flowed through the money market in December in connection with quarterly corporate dividend and tax payments, year-end switching transactions in the securities markets, and commercial bank portfolio adjustments in preparation for the publication of their December statements. However, this activity produced very little pressure in the money market. The banking system readily accommodated the credit demands of securities dealers, commercial and industrial borrowers, and nonbank financial intermediaries which converged upon the major money market banks over the December 9-12 popular dividend payment period and the midmonth tax date. During the two-week interval ended December 21, which included both the dividend and tax payment periods, total loans[3] and investments at the weekly reporting banks increased by approximately $4 billion, with the rise in loans accounting for about two thirds of the gain. For the month as a whole, bank credit at all commercial banks expanded much more than seasonally, in contrast to the relatively weak September-November performance.

[3] Exclusive of loans to banks and after deduction of valuation reserves.

Banks in the major money centers accumulated fairly large basic reserve deficits during the four December statement periods, mainly reflecting an expansion in their dealer lending operations (see Table II). In general, these banks managed to fill the bulk of their enlarged reserve needs in the Federal funds market, where a fairly good supply of reserves was usually available, and satisfied their residual reserve needs through moderate borrowing from the Federal Reserve Banks.

An estimated $5½ billion of negotiable time certificates of deposit matured at large commercial banks over the four statement periods ended December 28. As yields on some competing money market instruments—notably Treasury bills and bankers' acceptances—declined during the period, the 5½ per cent ceiling rate generally being offered on new time certificates became somewhat more attractive to investors. Consequently, banks were able to replace a substantial amount of the certificates which matured in December. Indeed, after declining for eighteen consecutive statement weeks, the amount of certificates outstanding at the large reporting banks in New York City expanded by approximately $100 million in the final statement period of the year. Moreover, a fair amount of the new certificates sold in December will not mature for three or four months, in contrast to the autumn sales pattern when many of the new certificates sold by banks were in the shortest maturity area. As a result, commercial bankers generally seemed much more optimistic about their ability to replace the large amount of certificates which will reach maturity in January.