The Money and Bond Markets in May

The financial community grew deeply apprehensive in May, as it weighed the potential economic consequences of the fiscal deadlock between the Congress and the Administration. Market uneasiness intensified after leaders in the House of Representatives decided at midmonth to delay a vote on the tax surcharge proposal at least until June. Many observers expected that further monetary restraint would be inevitable if no fiscal compromise materialized. Moreover, the sudden turmoil in France and renewed uncertainty in the international financial sphere contributed to the deepening tone of pessimism in the domestic financial markets. A somewhat more confident tone emerged in the money and bond markets toward the end of the month and rates eased somewhat, when hopes were rekindled that the Congress might at long last take positive action on the tax surcharge proposal. An undertone of uncertainty persisted, however, until the end of the month when the President stated that he would accept a $6 billion spending cut to insure a tax increase.

Despite the high interest rates that beset the money and bond markets, the demands for borrowed funds were substantial in May, adding to market pressures. There was a rapid flow of new and scheduled debt offerings from corporations and local governing authorities, as well as an expansion in the volume of short-term Treasury obligations because of the Treasury's May financing operations. At the same time, however, the volume of loanable funds available in these markets was generally quite limited since investment sources became reluctant to commit their funds to debt instruments, even at sharply lower prices.

In this setting, money market rates and yields on intermediate- and longer term obligations rose on a broad scale during the first two thirds of the month—frequently to record levels for modern times. As market rates increased sharply, observers grew fearful that a significant flow of funds out of savings institutions and commercial bank depository accounts into higher yielding obligations would result. The rates offered by the leading commercial banks on new negotiable time certificates of deposit (C/D's) were increased to the ceiling levels allowed under the provisions of Regulation Q (as revised in April) but, with yields on competing money market instruments rising more sharply, the net outstanding volume of C/D's contracted. In order to cover reserve deficits, the money market banks borrowed large sums in the Federal funds market, from their branches abroad and, to some extent, at the Federal Reserve "discount window". In addition, banks in the central money market reduced their holdings of short-term tax-exempt securities. As the month progressed, commercial bankers became increasingly apprehensive over their ability to raise funds with which to accommodate loan demands in the coming months. Several major commercial banks announced increases of from ¼ per cent to ½ per cent (applied to the face amount) in the interest rates that they charge on many types of consumer instalment loans, the first broad rise in these rates since mid-1966.

THE GOVERNMENT SECURITIES MARKET

During the first half of May, much of the activity in the market for Treasury notes and bonds arose in response to the Treasury's May financing, the terms of which were announced on May 1.[1] The Treasury extended to owners of two outstanding issues maturing on May 15 the right to exchange their holdings for new 6 per cent seven-year notes, and—in a separate phase of the operation—also offered 6 per cent fifteen-month notes for cash subscription, pricing both issues at par. Subscription books were open from May 6 through May 8 for the seven-year notes and on May 8 only for the fifteen-month notes (for which commercial banks were permitted to make full payment through credits to Treasury Tax and Loan Accounts). The market responded favorably to the financing announcement, and initial price adjustments in outstanding issues were fairly modest. In early "when-issued" trading, the new 6's of 1975 moved to a premium bid of 100⁶⁄₃₂ at a time when market sentiment was buoyed by reports that Paris had been selected as the site for preliminary Vietnam peace negotiations. However, the financing operation took place against a background of renewed uncertainty over the outlook for Congressional action on the proposed tax increase.

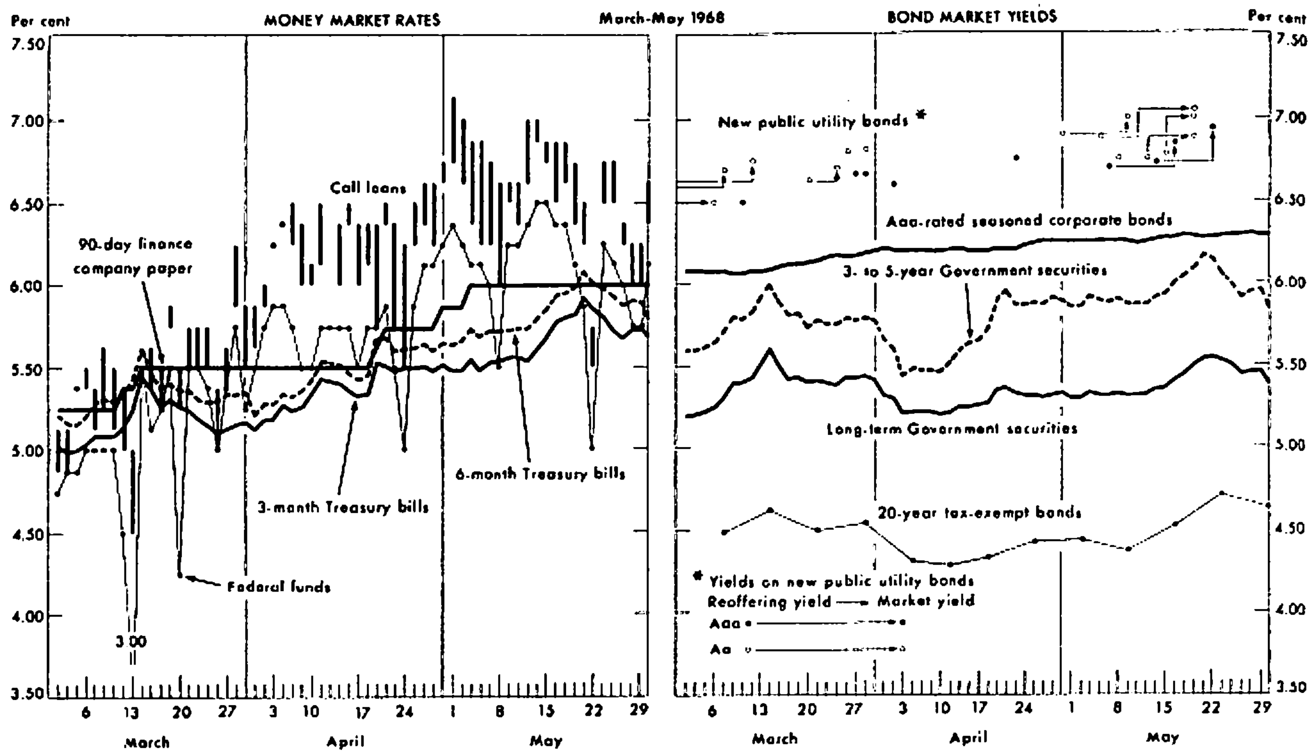
At the beginning of the month, some market observers had been inclined to think that prospects for an agreement between the Congress and the executive branch on a new tax and expenditures plan appeared to be improving. However, at a May 3 press conference, President Johnson, while strongly urging the Congress to take prompt action on a tax surcharge, indicated reservations about accepting a cut in expenditures greater than $4 billion. (The Senate had passed a bill combining a tax surcharge with a $6 billion spending cut. The larger spending cut was also favored by some key members of the House Ways and Means Committee.) Then, on May 6, the House Ways and Means Committee approved expenditure reductions of at least $4 billion and a tax increase closely in line with the Administration formula, and forwarded the bill to a Congressional conference group. Subsequently, the joint House-Senate Committee recommended a tax increase in combination with a $6 billion cut in expenditures. While the financial markets welcomed this news of positive action to achieve fiscal restraint, there was much uncertainty as to whether the tax-spending package could be passed by the full House and whether such a package would be acceptable to the Administration. Prospects for passage improved near the month end, however, when President Johnson agreed to accept the $6 billion spending cut.

Prices of Treasury notes and bonds fluctuated during the early part of the month in response to the barrage of international news and domestic fiscal developments. (See the right-hand panel of the chart for corresponding yield movements.) Some demand for the newly offered 6 per cent notes of 1975 (trading on a when-issued basis) arose largely in connection with swaps out of outstanding notes and bonds, but the availability in the market of rights was sizable and prices of the refunding issues moved narrowly during the subscription period. The results of the financing revealed that the Treasury had raised approximately $2 billion in new cash through its combined exchange and cash offering operation. About $6.7 billion of the $8 billion in Treasury notes and bonds maturing on May 15 was converted into the 6 per cent notes of 1975. The exchanges included $2.7 billion of the $3.9 billion of eligible maturing securities held outside the Federal Reserve Banks and Government accounts. The Treasury's cash offering of 6 per cent fifteen-month notes was oversubscribed. Total tenders exceeded $10 billion, including approximately $8.4 billion from commercial banks for their own account and $1.8 billion from all other sources. The Treasury accepted about $3.4 billion of these subscriptions, and set a 28 per cent allotment on subscriptions in excess of $100,000. (Subscriptions for $100,000 or less were allotted in full, while those exceeding $100,000—and thus subject to a partial allotment—were assured of at least $100,000.) The financing results surpassed the expectations of most market participants; however, there was little subsequent price reaction to the news.

As midmonth approached, commercial banks began to dispose of some coupon issues prior to the May 15 settlement date for the new fifteen-month Treasury notes (which, as noted, carried full Tax and Loan Account privileges and were, therefore, quite attractive to the banks). At the same time, investment buying of Treasury

[1] For details of the announcement, see this *Review* (May 1968), page 98.

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.

notes and bonds contracted while dealers grew restive over the very firm tone of the money market and the persistently high cost of financing their securities positions. Against this background, prices of intermediate- and long-term Treasury notes and bonds drifted lower. The downward price movement gathered momentum after the mid-month decision by leaders in the House of Representatives to delay a vote on the tax surcharge until early June or later. This news generated renewed uncertainty over the fiscal outlook and the future course of interest rates throughout the securities markets. In the Treasury coupon sector, dealers became increasingly anxious to reduce their positions while investors grew more reluctant to commit their funds to debt obligations.

Subsequently, the bond market atmosphere became deeply pessimistic. The slow pace of the Paris peace talk made market participants feel that no near-term reductio in defense expenditures could be expected. Furthermore many observers reasoned that the posture of monetary pol icy would continue to be restrictive for some time an might, in fact, become more so in the absence of fiscal restraint. The turbulent situation in France, the rising de mands for gold in the European markets, and renewed pressures on the pound sterling cast new shadows over the international financial scene and reinforced the uneasiness of domestic bond markets. In this setting, the improvement reported in the first-quarter United States balance-of payments position failed to elicit any significant optimism in the coupon sector. Thus, prices of Treasury notes and bonds moved steadily lower during the May 16 to May 21 period, primarily in response to selling pressure from professional sources, while investment activity subsided further.

An improved tone emerged in the coupon sector on May 23 when participants grew more optimistic about the fiscal restraint package, following comments by the Chairman of the House Ways and Means Committee to the effect that he expected the legislation to be passed. Subsequently, prices of Treasury notes and bonds moved irregularly higher. The market also reacted favorably when the President stated late in the month that he would reluctantly agree to a $6 billion cut in expenditures in order to gain Congressional approval of a tax increase.

In the market for Treasury bills, a fairly good atmosphere was evident in the opening days of May, when dealers anticipated that considerable reinvestment demand for bills might develop from sellers of rights to the Treasury's May refunding operations. However, a more cautious tone quickly appeared, as such demand fell short of expectations and high dealer financing costs (call loan rates posted by the major New York banks ranged from 6 to 7⅛ per cent in early May) generated selling pressure from professional sources. The perplexing, shifting status of the tax legislation in the Congress also exerted a continuous influence—sometimes bullish, at other times bearish—upon the bill sector. Although there was some net investment demand for the shortest bill maturities at times, investor interest in longer term bills was generally quite limited, while dealers became increasingly aggressive in their bill offerings. Against this background, rates for bills maturing beyond July generally moved higher through May 13 while rates on shorter bills declined slightly during this period. Subsequently, the bill market was adversely affected by the news that House action on the tax surcharge had been postponed and by renewed uncertainty over the future posture of monetary policy. From May 14 through May 21, bill rates rose sharply throughout the maturity spectrum in largely professional trading. (See the left-hand panel of the chart.) Investors did not contribute significantly to the selling pressure, but dealers termed investment demand disappointing. As bill yields moved higher, some market participants expressed concern that a further increase might be made in the Federal Reserve discount rate and in Regulation Q ceilings governing commercial bank time deposit rates.

A better tone developed in the bill market on May 22, and rates eased irregularly over the remainder of the month when demand expanded and participants became more hopeful that some fiscal restraint would materialize. Toward the close of the period, bill rates declined sharply in response to President Johnson's remarks on a spending reduction.

At the regular monthly auction of longer bill maturities on May 23, the new nine-month and one-year Treasury bills were awarded at average issuing rates of 6.086 per cent and 6.079 per cent, respectively (see Table III), in each case 42 basis points above the comparable average auction rates established a month earlier and the highest interest rates that the Treasury has paid on its direct obligations since the Civil War. However, at the final regular weekly bill auction of the month (held on May 27), average issuing rates on the new three- and six-month issues were set at 5.696 per cent and 5.869 per cent, respectively, 20 and 26 basis points above average auction rates on the comparable issues sold by the Treasury in late April but 15 and 13 basis points below rates set at the May 20 auction.

In the market for Government agency securities, prices of most outstanding issues declined steadily until late in the month in response to the same factors affecting prices in other markets for debt obligations. In addition, the announcement around midmonth that the Export-Import Bank would offer $500 million of participation certificates on June 4 also contributed to the nervousness of the agency sector. Several new agency issues reached the market in May, and at their generally attractive price levels drew fairly good receptions. On May 8, the Federal land banks offered at par $344 million of 6.30 per cent bonds (to replace $242 million of maturing securities and to raise $102 million in new cash); this issue was very well received at first. A week later, investors also accorded an excellent initial reception to a $326 million offering by the Federal Home Loan Banks of 6¼ per cent eleven-month notes (priced at par), which was used to roll over a maturing $300 million issue and to provide some new cash. On May 16, the Banks for Cooperatives floated $264 million of 6.20 per cent six-month debentures at par. The offering, which partially replaced a $352 million maturing issue, was well received at first but declined in price subsequently amid the generally cautious atmosphere prevailing in the market. On May 21, the Federal intermediate credit banks offered at par (for refunding purposes and to raise new cash) approximately $428 million of 6.45 per cent nine-month debentures which were well received. On May 29, the Federal National Mortgage Association offered $400 million of two-year 6.60 per cent debentures at par. The debentures, which replaced maturing securities, were generally well received.

OTHER SECURITIES MARKETS

In the markets for corporate and tax-exempt bonds, prices fluctuated widely during the early part of the month

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, MAY 1968

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

Factors	Changes in daily averages— week ended on					Net changes
	May 1	May 8	May 15	May 22	May 29	
"Market" factors						
Member bank required reserves*	+ 130	− 58	+ 330	− 85	+ 114	+ 428
Operating transactions (subtotal)	− 337	− 363	− 107	+ 29	− 230	−1,008
Federal Reserve float	− 380	+ 6	+ 26	+ 368	− 268	− 248
Treasury operations†	− 32	+ 149	− 120	− 122	+ 156	+ 30
Gold and foreign account	− 34	+ 46	+ 16	− 27	− 106	− 105
Currency outside banks*	+ 103	− 656	− 27	+ 86	+ 84	− 455
Other Federal Reserve accounts (net)‡	+ 4	+ 91	− 3	− 223	+ 3	− 128
Total "market" factors	− 207	− 421	+ 223	− 69	− 116	− 580
Direct Federal Reserve credit transactions						
Open market instruments						
Outright holdings:						
Government securities	+ 176	+ 97	− 131	+ 333	+ 187	+ 662
Bankers' acceptances	—	—	− 1	+ 1	—	—
Repurchase agreements:						
Government securities	+ 130	+ 272	+ 42	− 300	− 144	—
Bankers' acceptances	+ 13	+ 40	− 30	− 9	− 14	—
Federal agency obligations	+ 5	+ 10	− 7	− 5	− 8	—
Member bank borrowings	+ 23	+ 149	− 111	− 43	+ 95	+ 113
Other loans, discounts, and advances	—	− 1	− 1	—	—	− 2
Total	+ 348	+ 566	− 237	− 25	+ 121	+ 773
Excess reserves*	+ 141	+ 145	− 14	− 84	+ 6	+ 193

	Daily average levels					
Member bank:						
Total reserves, including vault cash*	25,514	25,717	25,373	25,377	25,258	25,450§
Required reserves*	25,247	25,305	24,975	25,063	24,949	25,108§
Excess reserves*	267	412	398	314	310	342§
Borrowings	674	823	712	669	764	728§
Free (+) or net borrowed (−) reserves*	− 407	− 411	− 314	− 355	− 445	− 386§
Nonborrowed reserves*	24,840	24,894	24,661	24,708	24,504	24,721§

	Changes in Wednesday levels					
System Account holdings of Government securities maturing in:						
Less than one year	+1,600	− 600	−3,180	− 284	+ 62	−2,411
More than one year	—	—	+3,565	—	+ 61	+3,626
Total	+1,600	− 600	+ 376	− 284	+ 123	+1,215

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 of five weeks ended on May 29.

Table II

RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS MAY 1968

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended on					Averages of five weeks ended on May 29*
	May 1	May 8	May 15	May 22	May 29*	
Eight banks in New York City						
Reserve excess or deficiency(−)†	22	53	10	39	11	27
Less borrowings from Reserve Banks	60	64	123	—	77	65
Less net interbank Federal funds purchases or sales(−)	582	696	781	431	65	511
Gross purchases	*1,093*	*1,405*	*1,438*	*1,215*	*1,152*	*1,261*
Gross sales	*510*	*709*	*657*	*784*	*1,087*	*749*
Equals net basic reserve surplus or deficit(−)	− 621	− 707	− 894	− 392	− 131	− 549
Net loans to Government securities dealers	623	575	511	497	385	518
Thirty-eight banks outside New York City						
Reserve excess or deficiency(−)†	18	38	40	45	21	32
Less borrowings from Reserve Banks	107	298	99	139	134	155
Less net interbank Federal funds purchases or sales(−)	186	666	688	878	345	553
Gross purchases	*1,688*	*2,011*	*2,157*	*2,202*	*1,895*	*1,991*
Gross sales	*1,503*	*1,345*	*1,470*	*1,323*	*1,550*	*1,438*
Equals net basic reserve surplus or deficit(−)	− 274	− 926	− 747	− 972	− 458	− 675
Net loans to Government securities dealers	484	366	116	163	2	226

Note: Because of rounding, figures do not necessarily add to totals.
* Estimated reserve figures have not been adjusted for so-called "as of" debits and credits. These items are taken into account in final data.
† 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 1968			
	May 6	May 13	May 20	May 27
Three-month	5.507	5.558	5.847	5.696
Six-month	5.697	5.750	5.995	5.869

	Monthly auction dates—March-May 1968		
	March 26	April 23	May 23
Nine-month	5.424	5.665	6.086
One-year	5.475	5.663	6.079

* 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.

in a rapidly changing atmosphere. The status of the tax surcharge legislation and the Vietnam peace talks were the major influences on the corporate and tax-exempt markets during this period.

In the corporate sector, where yields on newly issued bonds had climbed to near-record levels in late April and where an increasingly heavy calendar of scheduled flotations was on tap for May, a very cautious tone persisted at the beginning of the month. A $50 million A-rated 1993 utility issue carrying no special call protection was reoffered to yield a record 7¼ per cent and initially encountered some investor resistance. However, the tone of the corporate bond market briefly improved in the wake of the House Ways and Means Committee vote favoring a tax increase. Two new high-grade utility issues (one rated Aaa and the other Aa), both with five-year call protection, were reoffered on May 7 and 8 to yield 6.70 per cent and 6.75 per cent, respectively, about 5 basis points below the yields offered on recent comparable issues, and were accorded fairly good investor receptions. Although a slightly better undertone also emerged in the market for tax-exempt bonds during this period, the Blue List of dealers' advertised inventories remained quite high, the calendar of scheduled flotations continued to swell, and the adverse technical position of the sector exerted considerable restraint upon market sentiment.

As midmonth approached, the markets for corporate and tax-exempt bonds focused with increasing concern upon the uncertain outlook for final passage of the tax surcharge (and other pending fiscal measures), the related future course of monetary policy, and the unsettled international financial situation. The persisting firm tone of the money market and the unabated growth in the calendar of scheduled corporate and tax-exempt bond issues also contributed significantly to a weakening tone in these sectors. On May 14, an issue of $70 million of Aaa-rated telephone company debentures (due in 2008) with five years of call protection was offered to yield about 6.73 per cent and—in reflection of the rapidly worsening tone of the corporate sector—was poorly received by investors. During the same period, diminishing investor demand prompted the lifting of underwriter pricing restrictions on two corporate issues with unsold balances, and subsequent price concessions boosted yields by about 10 basis points in each case. In the tax-exempt sector, the Blue List climbed around midmonth to its highest level of the year and, despite the absence of much investor demand, a steady stream of new offerings was announced by state and local governmental authorities. Yields on seasoned tax-exempt issues rose sharply, while underwriters vainly attempted to stimulate investor interest in slow-moving recent issues by reducing prices to raise yields as much as 15 to 20 basis points.

The tone of the corporate and tax-exempt markets deteriorated further after midmonth. In the tax-exempt sector, as market yields continued to rise sharply, New York City on May 21 rejected bids for $71 million of its notes because of its dissatisfaction with the level of interest costs. At the same time, another large municipality canceled a scheduled bond sale as a result of the unsettled market conditions. In the corporate sector, syndicate price restrictions on several recent flotations were lifted, and yields were adjusted sharply higher.

In the closing days of May, a better tone emerged in the corporate and tax-exempt sectors and prices rallied, when participants became more optimistic about the Federal fiscal outlook.

Over the month as a whole, the Blue List of dealers' advertised inventories of tax-exempt bonds fell by $72 million to $513 million, while *The Weekly Bond Buyer's* average yield for twenty seasoned tax-exempt issues (carrying ratings ranging from Aaa to Baa) rose sharply to 4.64 per cent, 21 basis points above its level at the end of April. In the corporate sector, Moody's index of yields on Aaa-rated seasoned corporate bonds rose to 6.29 per cent by May 31, as against 6.25 per cent at the end of April. (See the right-hand panel of the chart.)

BANK RESERVES AND THE MONEY MARKET

The tone of the money market was generally firm in May. Although nationwide reserve availability was fairly stable over the month as a whole (see Table I), market expectations deteriorated, credit demands increased, and rates on a wide spectrum of money market instruments moved higher. The bulk of Federal funds transactions occurred in a 5¾ to 6½ per cent range, significantly above the 5½ per cent discount rate, and the rates posted by the major New York City banks on new loans to Government securities dealers frequently ranged from 6 per cent to 7 per cent. Before the end of May, rates on Treasury bills had climbed to record highs, bankers' acceptance rates had risen by ¼ per cent, and rates on directly placed and dealer-placed commercial paper were ⅛ per cent and ¼ per cent, respectively, higher than at the end of April. In the last few days of May, the money market was somewhat less taut and key market rates receded from their highs. Over much of the month, the leading commercial banks offered new time C/D's close to or at the ceiling rates permitted by Federal Reserve regulation, and encountered increasing difficulty in attracting such deposits.

During the first half of May, the reserve positions of banks in the major money market centers remained under substantial pressure (see Table II). In the two weeks ended on May 15, the basic reserve deficits of the major banks in New York City deepened somewhat, largely in reflection of increased bank lending to Government securities dealers during the Treasury's May financing operations coupled with declines in demand deposits. Nationwide reserve availability (as measured by net borrowed reserves) remained fairly steady during the early part of May and increased moderately around midmonth, when required reserves contracted. During much of this period, however, reserve distribution favored banks outside the money centers, and the reserve city banks turned to several sources in their search for funds to cover their mounting reserve deficiencies. Thus, they bid strongly for Federal funds at effective rates of from 6⅛ per cent to 6½ per cent and occasionally as high as a record 6⅝ per cent. At the same time, the pace of bank borrowing from their affiliates abroad accelerated during this period and balances due to the foreign branches of the leading New York City banks expanded steadily to record levels. Banks also continued to borrow a considerable volume of funds from the Federal Reserve Banks to fill their residual reserve needs, and member bank borrowings at the discount window averaged over $750 million in the two weeks ended on May 15. In addition, the New York City banks substantially reduced their holdings of short-term tax-exempt obligations during this period. During the second half of the month, the tone of the money market was generally firm but less taut than earlier. Nationwide reserve availability contracted approximately to its early May range, but banks in the central money market managed to accumulate a greater volume of excess reserves and moved into a somewhat more comfortable basic reserve position. Banks located outside the central money market remained under considerable reserve pressure, however.

Rates posted by the New York City banks on new negotiable time C/D's of under six-month maturity were generally quoted at the highest rates permitted by Federal Reserve regulation throughout the month. On C/D's maturing in 180 days or more, the 6¼ per cent ceiling rate was posted by several major money market banks early in the period and by virtually all banks at the close of the month. As the month progressed, and rates on other money market instruments rose above Regulation Q ceilings, the banks experienced some difficulty in replacing maturing C/D's. The major New York City banks reported a $260 million net decline in their outstanding C/D's over the five weeks ended on May 29.