The Money and Bond Markets in August

The financial markets staged a dramatic rally in mid-August in response to President Nixon's announcement of a basic shift in the nation's economic policies. Participants in the bond market were particularly encouraged by the ninety-day freeze on wages and prices as a step toward reducing domestic inflation.

The rally produced a record decline of 54 basis points in *The Weekly Bond Buyer's* index of municipal bond yields during the third week of the month. Yields on newly issued high-quality corporate bonds tumbled by as much as 80 basis points, while yields on Treasury securities of all maturities also fell rapidly. These precipitous declines in yields suggest that investors were trimming the inflationary expectations that had become embedded in yield structures. Stock markets also reflected the new-found optimism. On August 16 alone, the Dow-Jones average of industrial stock prices rose a record 32.93 points.

The euphoria sustaining the mid-August rally soon faded, but confidence remained strong that the new program had greatly improved the prospects for declining or at least steady interest rates in the months ahead. On September 2 the *Bond Buyer's* index of yields on municipals stood at 5.39 percent, down 66 basis points from the July 29 figure. On balance, yields on most long-term Treasury bonds fell during August by 28 to 35 basis points. At the end of the month, yields on Treasury issues with intermediate-term maturities were between 85 to 108 basis points below their levels at the end of July and rates on most Treasury bills were 79 to 112 basis points lower.

While yields in the capital and Government securities markets moved sharply lower over the month, developments in private money market rates were mixed. Interest rates on directly placed commercial paper with maturities of less than ninety days declined by about 25 basis points, but the offering rate on dealer-placed four- to six-month prime commercial paper fluctuated within a narrow range. The Federal funds rate remained steady in the vicinity of 5½ percent.

According to preliminary data, the narrowly defined money supply (M_1), adjusted for seasonal variation, increased in August at about a 3½ percent annual rate, the smallest percentage gain in seven months. M_2, a broader measure of the money supply, rose in August at a seasonally adjusted annual rate of approximately 5 percent, while the adjusted bank credit proxy increased by about 11 percent.

THE GOVERNMENT SECURITIES MARKET

A cautious atmosphere persisted in the market for United States Government securities during the first half of August. Market participants were apprehensive over the continued evidence of inflation and the increased pressure on the dollar in foreign exchange markets. There was concern that a rise in the prime rate and a firming in monetary policy lay ahead. Market sentiment changed dramatically at midmonth, however, when President Nixon made his announcement of a major shift in the nation's domestic and international economic policies. Investors responded optimistically to the Administration's program for a wage and price freeze and were further encouraged by the President's action to improve the international competitive position of the dollar. Yields on Government securities of all maturities plunged in the wake of the President's announcement, as many concluded that his program might foster a decline in interest rates during the next several months. Prices fluctuated thereafter as market participants began to assess the longer range implications of the new policies, but bidding in the August 31 auction of $1.25 billion of a 6¼ percent five-year two-month Treasury note was aggressive.

There was little change in yields on coupon securities during the early part of August, when a mood of apprehension continued to prevail in the market. On August 5, the Treasury auctioned $2.5 billion of new 6½ percent eighteen-month notes, which covered the attrition from an August refunding and raised about $1.1 billion of new cash. Bidding in the auction resulted in an average issuing price equivalent to a 6.54 percent yield. The auction elicited moderate interest from banks, which were permitted to pay for 50 percent of the awards by credits to their Treasury Tax and Loan Accounts. Toward the end

Table I

AVERAGE ISSUING RATES*
AT REGULAR TREASURY BILL AUCTIONS

In percent

Maturities	Weekly auction dates—August 1971				
	August 2	August 9	August 16	August 23	August 30
Three-month	5.273	5.372	4.921	4.747	4.549
Six-month	5.618	5.770	5.202	4.860	4.771
	Monthly auction dates—June-August 1971				
	June 24	July 27	August 24		
Nine-month	5.425	5.944	5.090		
One-year	5.507	5.953	5.126		

* 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.

of the second week of the month, yields on coupon securities drifted lower. This decline was mainly a result of professional demand and System purchases. Light dealer inventories at the start of the week created an excellent technical position, but investors remained very cautious.

When the market opened on Monday, August 16, investors responded enthusiastically to the President's announcement of the evening before. Yields on coupon securities fell sharply during the morning hours. Trading was extremely active as participants scrambled to cover short positions. Although investor demand contracted at midday, yields edged upward only slightly. Afternoon trading was less hectic, and yields fluctuated somewhat above the low levels prevailing during the morning. The following day, however, yields dropped sharply again as the rally continued despite occasional profit taking. Over this dramatic two-day period, yields on long-term Treasury bonds declined by about 20 basis points while yields on intermediate-term coupon issues plunged about 65 basis points.

During the remainder of the month, yields on coupon securities fluctuated over a wide range. The Treasury's announcement on August 25 that it would auction $1.25 billion of a new 6¼ percent five-year two-month note on August 31 prompted an initial rise in yields. However, the weakness was short-lived; many participants expected that bidding for the new notes would be strong, since the size of the financing was small and banks would be able to pay for the issue by crediting their Treasury Tax and Loan Accounts. The notes were subsequently auctioned at an average issuing price equivalent to a 5.98 percent yield. Over the month as a whole, yields on intermediate-term Treasury securities declined by 85 to 108 basis points while yields on most long-term bonds fell by 28 to 35 basis points.

Investor caution and a strong technical position also influenced the Treasury bill market in early August. Rates on Treasury bills were little changed during the first week of the month and trended moderately lower over the second week. Investor caution over the interest rate outlook and concern over the growing pressure on the dollar led to a steady demand for shorter maturities, and rates on bills were also pushed downward as foreign central banks invested a large volume of dollars acquired in exchange operations.

The President's August 15 announcement elicited a response in the Treasury bill market that was much the same as the response in the market for coupon issues. Rates on outstanding bills declined sharply during the early trading hours of Monday, August 16. Many participants viewed the rate levels reached in the morning as unrealistically low, and bidding in the regular weekly bill auction in the afternoon was hesitant. Nonetheless, reflecting the steep rate declines in outstanding issues, the average issuing rates for the new three- and six-month issues were set at 4.92 percent and 5.20 percent, respectively, 45 and 57 basis points below the levels established for comparable issues in the preceding week's auction (see Table I). Rates on outstanding bills plunged sharply again on Tuesday, and fluctuated over a wide range during the remainder of the month. Foreign demand continued and, in addition, dealers rebuilt their depleted inventories. By the end of August, rates on most issues were 79 to 112 basis points lower than at the beginning of the month.

The large foreign demand for bills that contributed to this dramatic decline in August materialized as a result of the massive flow of dollars to foreign institutions during the period, with some of these dollar balances being channeled into the bill market for short-term investment purposes. Marketable United States Government securities held in custody by the Federal Reserve Banks for foreign and international accounts rose to $20.0 billion on August 25, a gain of almost $1.6 billion in three weeks.

OTHER SECURITIES MARKETS

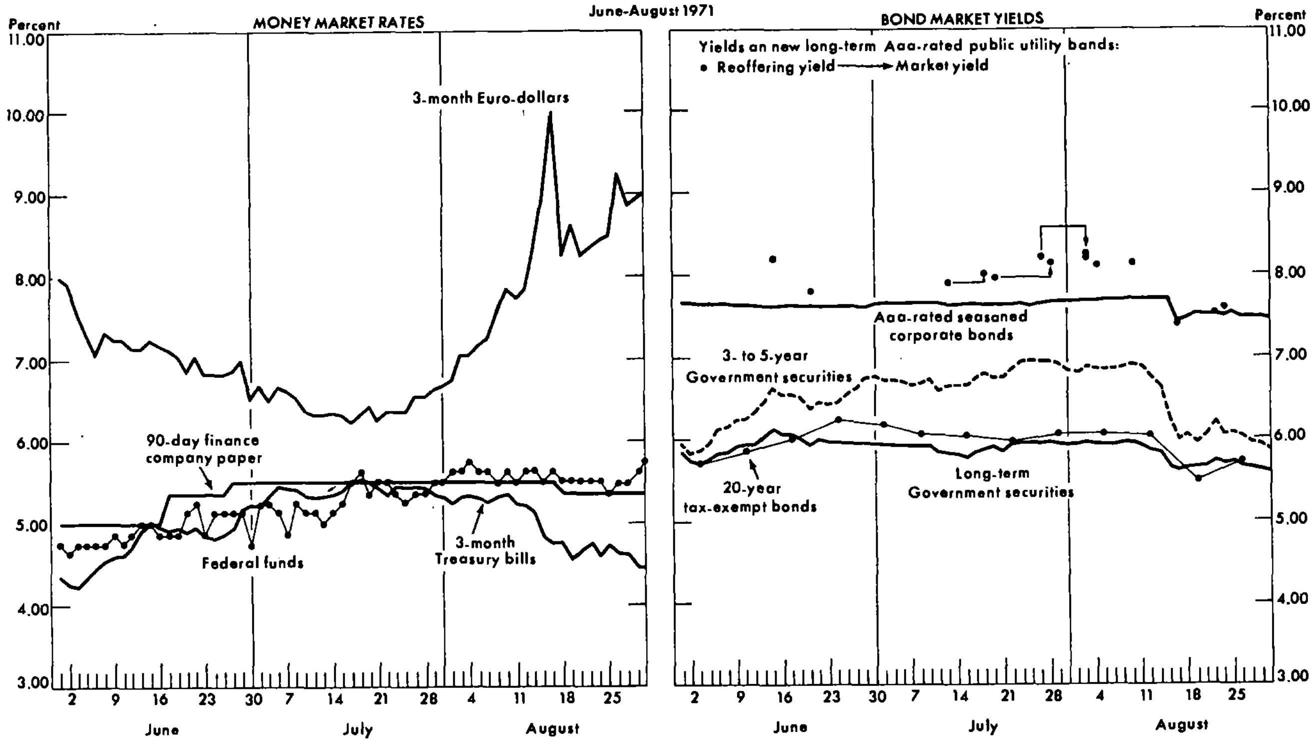
President Nixon's midmonth announcement triggered a dramatic and in some ways unprecedented rally in the corporate and tax-exempt bond markets. Indeed, in the days immediately following the President's statement the declines in some interest rates were the largest ever recorded over such a short interval, with the returns on some securities being pushed down to the lowest levels in almost four months. After a few days, however, investor enthusiasm waned somewhat and rates retraced part of the declines recorded earlier. Late in the month, rates declined again, leaving yields at the end of August far below their end-of-July levels.

Prior to the President's announcement, yields on corporate bonds had been little changed in quiet trading. The highlight of this period occurred on August 3, when the $100 million of Aaa-rated Indiana Bell Telephone Company debentures was marketed at an 8.20 percent yield. This yield provided about the same return as that on a smaller telephone issue marketed a week earlier, but 30 basis points more than another telephone issue of comparable size sold on July 13. The debentures received an enthusiastic response from institutional investors and sold quickly. Other newly issued corporate securities also sold well during the first half of August, aided by the relatively light schedule of new financing. On August 10, a $60 million Aaa-rated Consumers Power Company issue was marketed at an 8⅛ percent yield. The issue met a warm reception and was almost entirely sold at the end of the day. A $175 million issue of Aaa-rated International

Chart I

SELECTED INTEREST RATES

June-August 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 Aaa-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.

Bank for Reconstruction and Development bonds was marketed the following day at the same yield. Response to this offering was also favorable.

On Monday, August 16, corporate bond yields plummeted, and they continued to fall the following day, as investors responded to the President's new economic program with enthusiasm. Moody's index of yields on Aaa-rated seasoned corporate bonds plunged 27 basis points over this two-day period to 7.44 percent (see Chart I). This was the lowest level in over three months. The rally encouraged underwriters to offer on August 17 a Cincinnati Bell Telephone Company issue rated Aaa and priced to yield 7.40 percent, 80 basis points below the similarly rated Indiana Bell debentures marketed on August 4. Despite the aggressive pricing, 95 percent of the $50 million issue was reported sold on the first day. It appeared, however, that a substantial portion of the issue had been purchased by dealers anticipating still further price increases. As the third week of the month drew to a close, investor resistance started to develop in the corporate market and this issue was still not entirely sold.

Investor enthusiasm dampened further on Monday, August 23, when the Federal National Mortgage Association (FNMA) announced that it would sell $1 billion of debentures on Thursday of that week, the biggest FNMA offering ever. On that same Monday, a $60 million Aaa-rated Baltimore Gas and Electric Company issue was marketed at a yield of 7.52 percent. Investor response to this offering was poor, and less than 25 percent of the issue was sold the first day. This prompted underwriters to offer on the next day a $100 million Aaa-rated Southern Bell Telephone Company debenture issue at a yield of 7.60 percent, up 20 basis points from the Cincinnati Bell issue marketed on August 17. Despite the increase in yield, this issue also met first-day buyer resistance. Sales began to pick up toward the end of the month, however, after several major banks announced reductions in their interest charges on instalment and mortgage loans. By the end of August, the Southern Bell Telephone debentures were entirely sold, although approximately 5 percent of the Cincinnati Bell Telephone issue and 40 percent of the Baltimore Gas and Electric Company issue were still in syndicate hands.

Yields on municipal bonds remained steady over the first half of August and then dropped sharply after the Presidential announcement. *The Weekly Bond Buyer's* twenty-bond index of municipal bond yields was illustrative of these yield movements, fluctuating within 4 basis points over the first two weeks of the month and then plunging a record 54 basis points to 5.49 percent on August 19 (see Chart I). The decline brought this index to its lowest point in almost four months. Yields on some individual newly issued securities showed even more spectacular declines. On August 18, for instance, Tulsa, Oklahoma, awarded $16 million of A-rated bonds at a net interest cost of 4.78 percent. Underwriters offered the securities to the public the same day to yield from 3.10 percent on those maturing in 1973 up to 5.40 percent on those coming due in 1996. By comparison, another A-rated municipal bond issue had been marketed on August 10 with yields of 3.70 percent to 6.40 percent for similar maturities. Despite the lower yields of 60 to 100 basis points on the later securities, investors responded favorably. During the remainder of the month, yields on municipal bonds fluctuated widely. On September 2 the *Bond Buyer's* twenty-bond index stood at 5.39 percent, down 66 basis points from July 29.

A series of measures taken in August to keep down rates on mortgages, particularly those on home mortgages, should help support prices of corporate and municipal securities. Early in the month, the Federal Government, in a move designed to hold the ceiling rate on subsidized mortgages at its current level of 7 percent, announced that it would allow the Government National Mortgage Association (GNMA) to purchase up to $2 billion in mortgages at a discount. In turn, GNMA would sell the mortgages in the secondary market at competitive rates while absorbing the interest cost differential by means of its special assistance fund. Later in the month, the Federal Home Loan Bank Board reduced the required liquidity ratio at member institutions to free additional funds for mortgages. Since mortgages compete with corporate and municipal bonds for funds, these steps to hold down mortgage rates will also tend to reduce upward pressure on bond rates.

An interesting development in the tax-exempt market during August was the reduction in the size of a New York housing agency issue as a result of the Administration's freeze on prices. The New York agency had originally planned to offer $166 million worth of bonds on Monday, August 16, but delayed the offering to assess the impact of the President's program on the credit markets. The issue was finally marketed later in the week, but the amount of the financing was reduced by about $39 million. Reportedly, the reduction was made because eight of the agency's housing projects would have required increased rentals and, therefore, had to be postponed.

THE MONEY MARKET

Rate trends were mixed in the money market in August, with some rates rising, some fluctuating narrowly, and others declining. The average effective Federal funds rate advanced to 5.56 percent (see Chart I), up 25 basis points from July's average. Reflecting the disturbance in the international currency markets, three-month Euro-dollar rates soared to 10 percent on August 17 as participants scrambled to liquidate dollar claims and to borrow dollars for conversion into other currencies. At the close of the month, this rate stood at 9 percent, up 2⁹⁄₁₆ percentage points from the end of July. On August 3, a medium-sized Detroit bank raised its prime rate by ½ percentage point to 6½ percent, and late in the month a small St. Louis bank cut its prime rate to 5¾ percent. However, major money market banks held their prime lending rates at 6 percent. The offering rate on dealer-placed four- to six-month prime commercial paper and bid rates on bankers' acceptances fluctuated in a narrow range. On the other hand, interest rates on directly placed commercial paper with maturities of less than ninety days declined by about 25 basis points over the month.

The firm pressure on member bank reserve positions that had emerged in July was maintained in August as net borrowed reserves averaged $612 million (see Table II), little changed from the net reserve position that prevailed in July. Member bank borrowings dropped somewhat below their July average during the first two weeks of August, but then rose sharply during the third statement week. For the month of August as a whole, borrowings averaged $827 million, down $3 million from the average in July. As a result of this decline in borrowings and a $22 million fall in nonborrowed reserves, total member bank reserves decreased by $25 million, before seasonal adjustment. However, because bank reserves are typically characterized by a fairly large seasonal decline in August, member bank nonborrowed and total reserves, adjusted for seasonal variation, rose rapidly after declining substantially the previous month.

As for the monetary aggregates, preliminary data indicate that the growth in M_1 slowed to a seasonally adjusted annual rate of approximately 3½ percent in August (see Chart II). The gain for the most recent three months thus was only about 7½ percent, down from an increase of 11.6 percent for the three months ended in July. The growth in M_2 continued to slacken, with the August increase estimated at a 5 percent seasonally adjusted annual rate. However, there were very large increases in August in two categories of deposits that are not included in either M_1 or M_2. Government deposits at member banks rose rapidly, largely reflecting extensive purchases of Treasury nonmarketable certificates of indebtedness by foreign central banks, and large negotiable certificates of deposit at member banks also grew at a rapid pace. As a result, the adjusted bank credit proxy, which includes these deposits, increased at a seasonally adjusted annual rate of approximately 11 percent in August, the largest percentage gain since February and a rate well in excess of the ex-

Table II

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

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

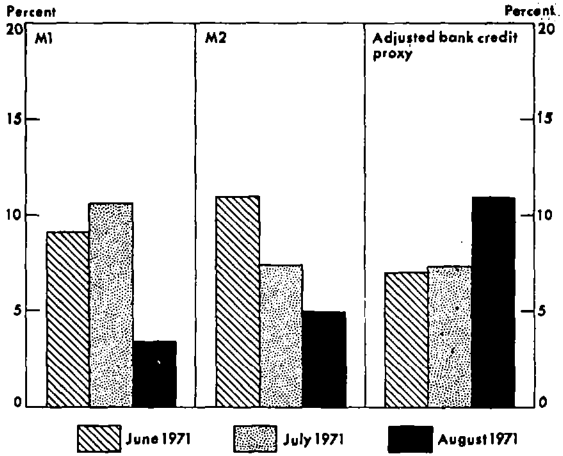
Factors	Changes in daily averages— week ended				Net changes
	August 4	August 11	August 18	August 25	
"Market" factors					
Member bank required reserves	+ 96	+ 157	— 77	+ 360	+ 536
Operating transactions (subtotal)	— 99	— 392	+ 68	— 106	— 529
Federal Reserve float	— 152	— 66	+ 226	+ 26	+ 34
Treasury operations*	+ 266	— 17	+ 125	— 113	+ 261
Gold and foreign account	— 37	— 81	— 121	— 8	— 247
Currency outside banks	— 51	— 161	— 372	+ 3	— 581
Other Federal Reserve liabilities and capital	— 126	— 66	+ 212	— 14	+ 6
Total "market" factors	— 3	— 235	— 9	+ 254	+ 7
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	+ 116	— 33	— 103	+ 292	+ 272
Outright holdings:					
Treasury securities	+ 101	+ 50	+ 84	+ 397	+ 632
Bankers' acceptances	— 3	— 5	— 2	+ 6	— 4
Repurchase agreements:					
Treasury securities	+ 40	— 49	— 157	— 101	— 267
Bankers' acceptances	— 8	— 4	— 10	—	— 22
Federal agency obligations	— 14	— 25	— 18	— 10	— 67
Member bank borrowings	+ 219	— 171	+ 587	— 409	+ 226
Other Federal Reserve assets†	+ 35	+ 32	— 213	— 318	— 464
Total	+ 370	— 172	+ 271	— 434	+ 35
Excess reserves	+ 367	— 407	+ 262	— 180	+ 42
	Daily average levels				Monthly averages
Member bank:					
Total reserves, including vault cash	30,894	30,330	30,669	30,129	30,506‡
Required reserves	30,460	30,303	30,380	30,020	30,291‡
Excess reserves	434	27	289	109	215‡
Borrowings	764	593	1,180	771	827‡
Free, or net borrowed (—), reserves	— 330	— 566	— 891	— 662	— 612‡
Nonborrowed reserves	30,130	29,737	29,489	29,358	29,679‡
Net carry-over, excess or deficit (—)§	18	230	79	135	116‡

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 four weeks ended August 25.
§ Not reflected in data above.

Chart II

CHANGES IN MONETARY AND CREDIT AGGREGATES

Seasonally adjusted annual rates



Note: Data for August 1971 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 sources of funds, such as Euro-dollar borrowings and the proceeds of commercial paper issued by bank holding companies or other affiliates.

Source: Board of Governors of the Federal Reserve System.

pansion of both M_1 and M_2. In each of the four preceding months, the expansion of the proxy had been quite modest relative to the money supply measures.

Commercial bank loans rose substantially in August, with the increase at least partly related to the international currency crisis. Most of the rise occurred during the third statement week of the month, immediately following President Nixon's statement concerning the temporary suspension of the convertibility of the dollar into gold. During that week, business loans at weekly reporting banks, including loans sold to affiliates, climbed by $799 million, contrasting with the $277 million decline registered over the comparable period in 1970. Almost half of the increase was in bankers' acceptances, many of which were apparently related to foreign transactions, while loans to foreign industrial and commercial businesses accounted for almost one quarter of the gain. Borrowings at weekly reporting banks by foreign commercial banks also jumped that week by $700 million. Presumably, foreign corporations and banks borrowed dollars to exchange them for other currencies in anticipation of a depreciation of the dollar in foreign exchange markets. A similar surge in commercial bank loans to foreigners occurred during the last major currency crisis in May.