The Money and Bond Markets in September

Bond prices retreated during much of September from the peaks reached in the wake of the President's mid-August announcement of his new economic program, but prices rose sharply late in the month as investors stepped up their buying of new corporate and municipal issues. The large volume of such financing contributed to the very cautious atmosphere around midmonth, as did concern about how strong Phase Two of the Government's anti-inflation program would be. Administration reassurances that Phase Two would have "teeth" contributed to the improvement in market atmosphere late in the month. The continuing moderation in the growth of the money supply also strengthened market expectations that a decline in short-term interest rates—and ultimately long-term rates—would follow. Preliminary data for September indicate that the narrow money supply (M_1) recorded its first decrease since February 1970 and that the broader measure of the money supply (M_2) rose only slightly.

To widen the base of System open market operations and to add breadth to the market for agency securities, the Federal Open Market Committee announced on September 16 that it had authorized outright purchase and sale transactions in securities of Federal agencies. Prior to this, open market operations in Federal agency issues had been confined to repurchase agreements with securities dealers. Prices of agency issues rallied sharply in response to this news. The System conducted such operations for the first time one week later.

THE MONEY MARKET

Rates on most money market instruments were little changed in September, except for declines in Euro-dollar and Federal funds rates. Euro-dollar rates had risen sharply amidst the turmoil in the international currency markets during the first half of August (see Chart I). The three-month Euro-dollar rate, which had briefly reached 10 percent in mid-August, dropped to 7¹⁵⁄₁₆ percent by the end of September, still well above the average of about 6½ percent which had prevailed in July. The rate on Federal funds averaged 5.67 percent during the first half of September, compared with an average of 5.56 percent in August, but declined to 5.44 percent on average over the remainder of the period. Rates on bankers' acceptances were reduced by ⅛ percentage point at the end of September, while rates on dealer-placed commercial paper were raised by ⅛ percentage point during the month. A number of banks also raised their offering rates on large negotiable certificates of deposit (CDs) by about ⅛ percentage point early in the month. However, a strong influx of CD funds after midmonth induced some banks to roll back the rate increases around the end of September.

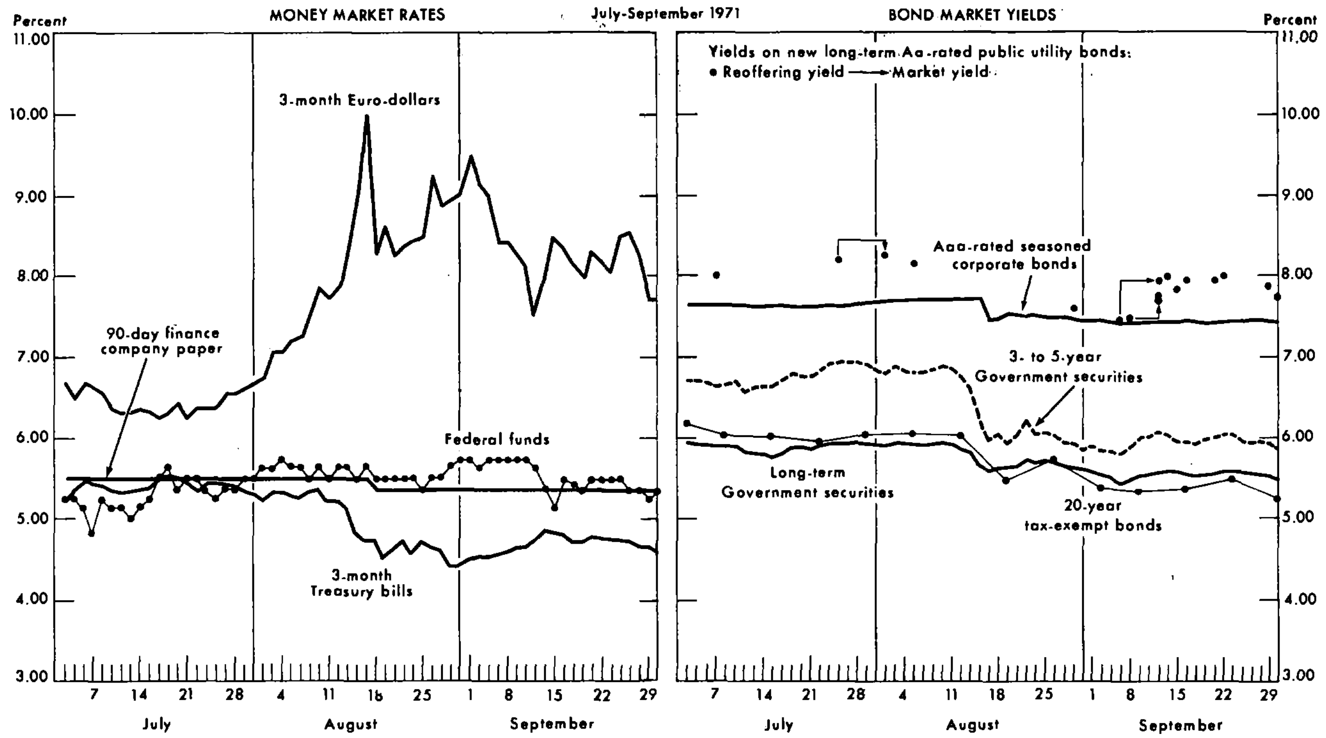
Pressure on the reserve positions of member banks lessened considerably in September. During the first two statement weeks the net reserve position showed little change from August, but there was a sizable decline in member bank borrowings at the Federal Reserve discount window as the month progressed. For the month as a whole, net borrowed reserves fell to $265 million (see Table I) from an average of more than $600 million in the preceding two months, largely as a result of a decline in average borrowings of some $290 million from the August level.

After several months of rapid advance, M_1 reached a plateau in the third quarter (see Chart II). Based on preliminary data, M_1 actually declined at an annual rate of approximately 4 percent on a seasonally adjusted basis in September. This brought the annual rate of growth of M_1 to about 3 percent over the three months that ended in September and about 7 percent over the six months ended then. This represents a substantial moderation from the 10 percent annual growth rate of M_1 over the first half of the year and is considerably more in keeping with a healthy economic expansion.

The decline in M_1 during September was reflected in a marked slowing of the growth of M_2, which adds to M_1 commercial bank savings and time deposits other than large CDs. M_2 grew at a seasonally adjusted annual rate of only about 1 percent in September. This brought the annual rate of growth of M_2 to about 4½ percent over

Chart I

SELECTED INTEREST RATES



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 Aa-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.

the third quarter and 8½ percent over the six months that ended in September. In contrast, M_2 had increased at an annual rate of 15½ percent during the first half of the year.

While the growth of the money supply measures has moderated in recent months, the growth of the adjusted bank credit proxy accelerated in August and continued rapid in September. The credit proxy increased at a seasonally adjusted annual rate of about 9 percent over the third quarter and about 7¾ percent over the six months ended in September. While the greater increase in the credit proxy compared with M_2 during August was mainly attributable to a substantial rise in Government deposits, which are included in the proxy but not in M_2, a very substantial increase in large CDs accounted for much of the September divergence. As shown in Chart III, large CDs have expanded rapidly in recent months while the rate of growth of other time and savings deposits has slackened from the rapid pace of the first half of the year.

THE GOVERNMENT SECURITIES MARKET

In the United States Government securities market, participants became more cautious in early September as they began to focus on the difficulties of formulating a national program to follow the wage-price freeze. Investor buying receded and dealer selling exerted upward pressure on yields. Congestion in the corporate bond market also contributed to the downward drift in prices. Subsequently, Administration reassurances, a pickup in the corporate market, and a decline in the Federal funds rate contributed to a marked upsurge in prices.

Table I

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

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

Factors	Changes in daily averages— week ended					Net changes
	Sept. 1	Sept. 8	Sept. 15	Sept. 22	Sept. 29	
"Market" factors						
Member bank required reserves	— 175	— 450	+ 41	+ 195	— 320	— 709
Operating transactions (subtotal)	+ 51	—233	+ 296	+ 330	— 435	+ 9
Federal Reserve float	— 205	+ 102	+ 314	+ 693	— 731	+ 173
Treasury operations*	— 45	— 76	— 36	— 374	— 242	— 773
Gold and foreign account	— 10	+ 29	+ 26	— 11	+ 4	+ 38
Currency outside banks	+ 392	— 190	— 187	+ 26	+ 614	+ 655
Other Federal Reserve liabilities and capital	— 81	— 98	+ 179	— 4	— 79	— 83
Total "market" factors	— 124	— 683	+ 339	+ 525	— 755	— 700
Direct Federal Reserve credit transactions						
Open market operations (subtotal)	+ 446	+ 411	— 79	— 447	+ 742	+1,073
Outright holdings:						
Treasury securities	+ 282	+ 91	— 130	+ 91	+ 332	+ 666
Bankers' acceptances	—	—	— 2	— 1	— 3	— 6
Federal agency obligations	—	—	—	—	+ 52	+ 52
Repurchase agreements:						
Treasury securities	+ 117	+ 218	+ 76	— 411	+ 263	+ 263
Bankers' acceptances	+ 20	+ 34	— 3	— 51	+ 39	+ 39
Federal agency obligations	+ 27	+ 68	— 20	— 75	+ 59	+ 59
Member bank borrowings	— 65	+ 59	— 308	— 129	+ 98	— 345
Other Federal Reserve assets†	+ 50	+ 40	+ 77	+ 29	+ 40	+ 236
Total	+ 431	+ 510	— 310	— 547	+ 881	+ 965
Excess reserves	+ 233	— 119	+ 42	— 20	+ 126	+ 262
	Daily average levels					**Monthly averages**
Member bank:						
Total reserves, including vault cash	30,519	30,850	30,851	30,636	31,082	30,788‡
Required reserves	30,195	30,645	30,604	30,409	30,729	30,516‡
Excess reserves	324	205	247	227	353	271‡
Borrowings	706	765	457	328	426	536‡
Free, or net borrowed (—), reserves	— 382	— 560	— 210	— 101	— 73	— 265‡
Nonborrowed reserves	29,813	30,085	30,394	30,308	30,656	30,251‡
Net carry-over, excess or deficit (—) §	66	170	120	174	4	107‡

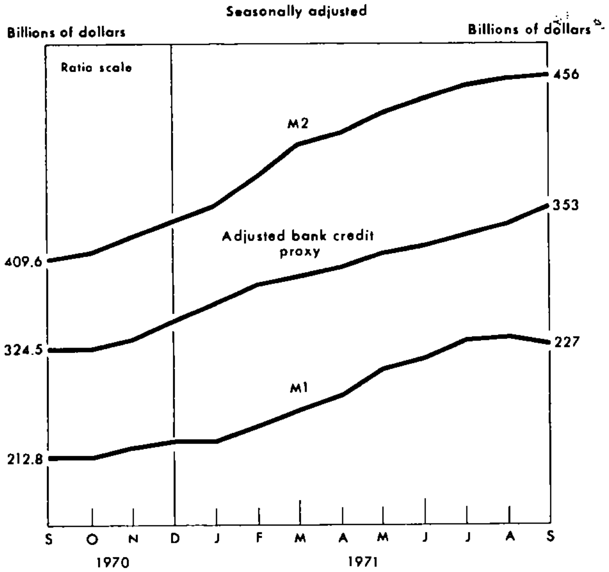
Note: Because of rounding, figures do not necessarily add to totals.
* Includes changes in Treasury currency and cash.
† Includes assets denominated in foreign currencies.
‡ Average for five weeks ended September 29.
§ Not reflected in data above.

The Federal Open Market Committee's statement on September 16 that it had authorized the outright purchase and sale of Federal agency securities by the Federal Reserve Bank of New York for the System Open Market Account had an immediate bullish effect in the agency market. When actual purchases were made a week later, that market again responded positively. In the accompanying initial guidelines, the Committee stated that the operations are not designed to support individual sectors of the market or to channel funds into issues of particular agencies. System holdings will be limited to issues outstanding in amounts of $300 million or over if maturing in five years or less and $200 million or over if maturing in more than five years. In addition, System holdings of any issue are not to exceed 10 percent of the amount of the issue outstanding. No new issue will be purchased in the secondary market until at least two weeks after the issue date. While no specific limit was set for the System's total holdings of the issues of any one agency, as an initial objective the System will aim at building a modest portfolio of fully taxable issues for which there is an active secondary market. Purchases of agency issues will be an integral part of total System open market operations to supply bank reserves, with the amount and timing of acquisitions designed to avoid undue market effects.

As the month opened, prices of intermediate Treasury issues declined somewhat in response to some selling of the new 6¼ percent "when-issued" note of 1976, which was auctioned on August 31, as well as some sales of other issues by dealers who were positioning themselves for the new note. Prices soon steadied and then began to move higher on most intermediate- and long-term notes and bonds over the next few trading days. Participants were generally optimistic about the near-term outlook because of the reduction in the British bank rate from 6 percent to 5 percent and the overall trend of domestic rates in recent weeks. Prices of coupon issues began to drift lower on the Wednesday following Labor Day, when some profit taking emerged, and dropped still further over the remainder of the week after President Nixon's speech to the Congress promising a termination of the wage-price freeze on November 13 but providing no details regarding a substitute program. Prices of coupon issues continued to decline in mainly professional trading after the weekend, affected to some extent by investor resistance to lower yields in the corporate bond markets.

At the lower price levels some demand began to emerge

Chart II
MONETARY AGGREGATES
Seasonally adjusted



Note: Data for September 1971 are preliminary estimates.

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.

at midmonth, especially for issues in the intermediate maturity range, and a firmer tone developed as selling pressures also subsided. Weekly banking statistics showing a slower growth in the money supply and the President's statement that Phase Two would also be strongly anti-inflationary provided further support to the coupon market's improvement at this time. The rally did not extend beyond the weekend, however, and the market resumed its decline during most of the week of September 20. Demand was again insignificant at the start of that week, and dealers had to reduce their prices in order to elicit some investor interest. Following President Nixon's September 23 remarks giving further clues about his Phase Two plans, the market firmed somewhat and then improved substantially during the final week in response to significant investor interest in all sectors of the bond market. Over the month as a whole, yields on most coupon issues declined by 3 to 30 basis points.

The bill market reacted in much the same fashion to outside events as did the coupon market, but two additional factors were major influences during September. Bill rates had declined during August in large part because of the substantial demand from several foreign central banks. These banks had accumulated sizable dollar holdings and had invested them in marketable and nonmarketable United States Treasury issues. With the contraction of this demand, upward pressure on bill rates was almost inevitable during September since alternative sources of demand of equal magnitude were unlikely. In addition, because of the high Federal funds rate relative to the return on bills, dealers were unwilling to hold heavy inventories and exerted selling pressure much of the time during the first half of the month. With the rise in bill rates and the concomitant easing of their borrowing costs as the Federal funds rate declined, dealers were in a more comfortable position in the final half of the month. As the period drew to a close, however, there was some increased concern among participants about the possibility that foreign central banks might soon redeem a large part of the United States Treasury obligations that they had recently purchased. Since the Treasury would need to substitute domestic funds for foreign should this occur, a cautious tone emerged with regard to this possible future pressure on the market. In addition, there was discussion of the Treasury's seasonal cash needs during the period ahead and the probability of bill sales to meet these. Rates on most bills due within three months rose by 5 to 26 basis points in September, while longer bills were 21 to 33 basis points higher.

OTHER SECURITIES MARKETS

As the month of September opened, the corporate bond market was congested with the sizable unsold balances of bonds floated unsuccessfully at the end of August. However, sparked by rumors of an imminent cut in the prime rate at commercial banks following the full percentage point reduction in the British bank rate, the market rallied in unusually heavy preholiday trading on the Friday preceding Labor Day, and the unsold balances were reduced substantially. Hoping to capitalize on the increased investor receptivity, underwriters priced $35 million of Aa-rated utility bonds at a yield of 7.45 percent on the Tuesday following the holiday, the lowest return on such an offering since early April. Many investors balked at this aggressive pricing and also refused on the next day to purchase another similarly rated issue which provided a return only 2 basis points higher. The addition of these bonds to unsold inventories from other recent flotations had a dampening effect on the market, and corporate bond prices fell on September 9 after President Nixon announced the termination date for the wage-price freeze without detailing Phase Two. The price decline continued into the next week when, faced with the heaviest weekly schedule since May, underwriters released from price restrictions three issues with balances amounting to about $150 million. Upward yield adjustments as high as 36 basis points resulted, and the market began to stabilize in response to these and other price reductions. Investors remained selective, however, and no overall enthusiasm developed until the President assured the nation that Phase Two of his domestic economic program would contain "teeth". The market rallied late on the afternoon of September 16 following the President's press conference and continued to gain on the following day. During the next week, however, participants were again confronted by a heavy new supply with little retail demand and, despite a rise in yields on new Aa-rated utility bonds to 8 percent, strong buying interest did not emerge until the period drew to a close. Then, some short covering occurred and increased demand from institutional investors also emerged. The corporate bond market was further buoyed at that time by the last of President Nixon's economic pronouncements during the month, and yields declined toward the end of September amid strong investor demand. While corporate bond yields rose on balance over the month, they closed well below the levels which prevailed just prior to the President's August 15 address.

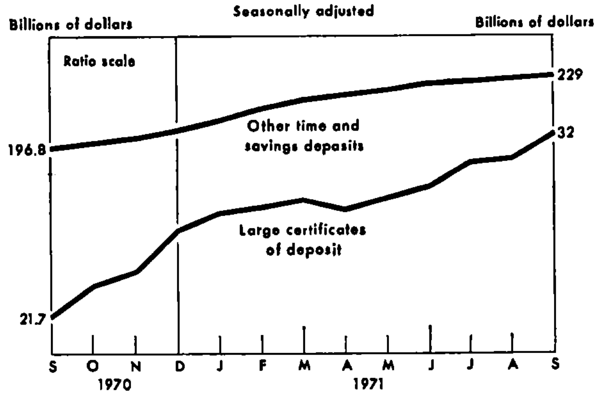
The pattern of price behavior in the market for tax-exempt bonds was quite similar to that in the corporate market during much of September, despite the fact that there was a very moderate schedule of new municipal issues until late in the month. The similarity of behavior resulted from the aggressive pricing by underwriters in both areas, with subsequent adjustments required by investor resistance, and from the high degree of responsiveness of these markets to the same rumors and news reports. Largely as a result of substantial gains in the final week, however, municipal bond yields declined over the month as a whole. *The Weekly Bond Buyer's* index of yields on twenty municipal bonds fell to 5.24 percent on September 30 from 5.39 percent on September 2, reaching its lowest level since April.

At the start of September, the municipal bond market also was burdened with some slow-selling issues which had been marketed on the last day of August. As was the case in the corporate bond market, it was not until the reduction in the British bank rate and the ensuing rumor about a probable decline in the domestic prime rate that dealers were able to retail the remainder of these bonds, which then moved to a premium in secondary trading. Prices on tax exempts held steady in light trading on the Tuesday after Labor Day, as most participants awaited pricing of the week's two largest offerings on Wednesday. These were a $100 million Aa-rated state of California issue and $75 million of state of New Jersey Aaa-rated bonds. Priced to yield substantially less than bonds floated the week before, the new California and New Jersey obligations encountered a chilly response from investors, and only about one third of each issue had been sold by the following week

Chart III

LARGE CERTIFICATES OF DEPOSIT AND OTHER TIME AND SAVINGS DEPOSITS

Seasonally adjusted



Note: Data for September 1971 are preliminary estimates.
Source: Board of Governors of the Federal Reserve System.

Table II

AVERAGE ISSUING RATES* AT REGULAR TREASURY BILL AUCTIONS

In percent

Maturities	Weekly auction dates—September 1971			
	September 3	September 13	September 20	September 27
Three-month	4.538	4.834	4.743	4.676
Six-month	4.846	5.085	4.993	4.973

Maturities	Monthly auction dates—July-September 1971		
	July 27	August 24	September 22
Nine-month	5.944	5.090	5.242
One-year	5.953	5.126	5.279

* 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.

when underwriters consented to price reductions on them.

While the tone of the municipal market had already improved with the repricing of the California and New Jersey bonds and the sellout of $98 million of New York State Power Authority term bonds, a further boost was temporarily provided by the President's press conference remarks on September 16 concerning a strong Phase Two. Again, however, the positive effect of these remarks did not last beyond the weekend, and prices resumed their downtrend over the next several days. Uppermost in the minds of many participants was the record-breaking calendar of new tax exempts scheduled for the week beginning September 27; close to $1 billion of bonds was slated for competitive sale at that time. The largest items included were $335 million of New York City bonds and $258 million of housing authority bonds. When the bonds were actually marketed, investors responded quite favorably to many of them despite a reduction in their yields of some 15 to 20 basis points from comparable issues the week before.