The Money and Bond Markets in February

During the first part of February, investor concern over the potential inflationary impact of the Administration's sizable projected Federal budget deficit led to a lack of confidence in the sustainability of current long-term yield levels. Yields on longer maturities increased, while conditions in the money market remained comfortable, resulting in a sharply rising yield curve. Foreign central banks contributed to the downward pressure on short-term interest rates, as they bought Treasury bills with the dollars taken in from the exchange markets.

With the month about a third over, the tone of the market for longer term securities began to improve. A growing skepticism emerged that the Federal budget deficit would be as large as officially projected. The market was encouraged by the testimony of Chairman Burns of the Board of Governors of the Federal Reserve System before the Joint Economic Committee of the Congress on February 9. Chairman Burns stated that the Federal Reserve "does not intend to let the present recovery falter for want of money or credit" but that it "will not release the forces of a renewed inflationary spiral". Yields on Government issues worked irregularly lower over the remainder of the month. Yields in the corporate and municipal sectors also declined for a time, but they began to rise again toward the month end as investors proved apathetic to new offerings. Rates on Treasury bills also rose late in the month, as both the Treasury and the Federal Reserve added to market supplies.

THE MONEY MARKET

Money market conditions remained comfortable in February, as the Federal Reserve continued to provide reserves generously. The effective rate on Federal funds averaged 3.29 percent, down 21 basis points from January and the lowest monthly average since July 1963. This rate has moved progressively lower in each month since last August when the average stood at 5.57 percent. With Federal funds generally trading more than a full percentage point below the discount rate of 4½ percent, member banks had no incentive to borrow from the Federal Reserve Banks. Consequently, such borrowings stayed at frictional minimum levels and averaged only \$23 million for the month (see Table I), about the same as in January. Net free reserves averaged \$177 million, a decrease of \$5 million from January.

The easier money market climate was reflected in further declines in nearly all short-term interest rates. For example, by February 23 rates on bankers' acceptances had been reduced by ⅜ percentage point, while bank offering rates on newly issued negotiable certificates of deposit had declined by about ¼ to ⅜ percentage point. Rates on most maturities of commercial paper were lowered by ⅛ to ½ percentage point. The largest drops in rates were among instruments of the shorter maturities, indicative of the general uncertainty among market participants about the near-term outlook for interest rates. During the last few days of the month, however, these rate reductions were partially reversed.

In response to the earlier declines in rates, a major New York City bank which pegs its minimum business loan rate to market interest rates reduced its prime rate to 4½ percent effective February 15, joining two others which had made a similar move two weeks earlier. Shortly thereafter, another large New York City bank that does not follow a "floating" prime rate policy announced a ¼ percentage point reduction, bringing its prime rate to the 4½ percent level. Other major money market banks resisted the move, after having just lowered their prime rates to 4¾ percent in January in the face of sluggish business loan demand. These banks may have been waiting to see whether some signs of a pickup in business loan demand at New York City banks would be sustained. Nonetheless, effective February 28 another New York City bank that had maintained a 4½ percent prime rate all month lowered its floating prime rate to 4⅜ percent. This marked the lowest prime rate in over a decade and set a 4⅜ to 4¾ percent range for prime rates quoted at the month end.

The narrowly defined money supply (M_1)—adjusted demand deposits and currency held by the public—rose sharply in February, following modest increases at seasonally adjusted annual rates of 2.6 percent in December and 3.2 percent in January. Over the three months ended in February, M_1 rose at an annual rate of about 6½ percent (see Chart I). By comparison, M_1 increased 6.2 percent over 1971 as a whole. Oftentimes, this aggregate displays wide short-term fluctuations, and therefore it is generally relevant to look at growth rates extending over several months.

The growth of the broader money supply (M_2) also further accelerated in February. The expansion of consumer-type time and savings deposits—which are included in M_2 though not in M_1—continued at a strong pace, thereby contributing to the rapid growth of the more inclusively defined money supply. Over the three months ended in February, M_2 increased at a strong 13 percent annual rate.

In contrast, the growth of the adjusted bank credit proxy slowed in February because of a sharp decline in seasonally adjusted United States Treasury deposits at member banks, which partially offset the strong gains in demand and time deposits. Aside from its performance in February, the growth of the adjusted proxy has been somewhat more steady over the past year than the growth of M_1 or M_2. Over the three-month period ended in February, the adjusted proxy rose at an estimated 10 percent rate, in line with its 9.5 percent growth over all of 1971.

THE GOVERNMENT SECURITIES MARKET

A generally cautious and sensitive atmosphere characterized the Government securities market at the beginning of February. To be sure, the Treasury's large refunding operation had been very successful.[1] The $1.6 billion takedown of the new ten-year 6⅜ percent bonds was considerably larger than most market participants had expected. But investors were concerned that the projected budget deficit would lead to a renewal of inflationary forces. There was also a feeling that short-term interest rates might soon rise as the economy expanded and exert upward pressure on intermediate-term yields.

With the month less than a third over, stronger demand developed for Treasury coupon issues at slightly lower price levels as banks reached out for higher yields. The remarks of Chairman Burns before the Joint Economic Committee on February 9 also added to the market's confidence. Beyond this, the persistence of the Federal funds rate in a 3¼ to 3½ percent range suggested that the System was providing an ample supply of nonborrowed re-

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, FEBRUARY 1972

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

Factors	Changes in daily averages— week ended				Net changes
	Feb. 2	Feb. 9	Feb. 16	Feb. 23	
"Market" factors					
Member bank required reserves	+ 209	+ 348	— 123	+ 272	+ 706
Operating transactions (subtotal)	— 15	— 229	— 155	+ 572	+ 173
Federal Reserve float	— 234	— 32	— 39	+ 335	+ 80
Treasury operations*	+ 85	+ 40	+ 209	+1,018	+1,358
Gold and foreign account	— 6	+ 10	— 141	— 414	— 551
Currency outside banks	+ 230	— 179	— 388	— 501	— 838
Other Federal Reserve liabilities and capital	— 90	— 73	+ 204	+ 134	+ 175
Total "market" factors	+ 194	+ 119	— 278	+ 844	+ 879
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	— 197	— 368	+ 735	— 416	— 246
Outright holdings:					
Treasury securities	— 195	— 357	+ 130	+ 53	— 369
Bankers' acceptances	—	— 6	— 1	— 4	— 11
Federal agency obligations	— 2	— 5	+ 129	+ 12	+ 134
Repurchase agreements:					
Treasury securities	—	—	+ 406	— 406	—
Bankers' acceptances	—	—	+ 46	— 46	—
Federal agency obligations	—	—	+ 25	— 25	—
Member bank borrowings	+ 4	+ 27	— 25	— 1	+ 5
Other Federal Reserve assets†	+ 51	+ 28	— 157	— 576	— 654
Total	— 142	— 314	+ 553	— 991	— 894
Excess reserves	+ 52	— 195	+ 275	— 147	— 15

	Daily average levels				Monthly averages
Member bank:					
Total reserves, including vault cash	32,435	31,892	32,290	31,871	32,122‡
Required reserves	32,190	31,842	31,965	31,693	31,923‡
Excess reserves	245	50	325	178	200‡
Borrowings	16	42	17	16	23‡
Free, or net borrowed (—), reserves	229	8	308	162	177‡
Nonborrowed reserves	32,419	31,850	32,273	31,855	32,099‡
Net carry-over, excess or deficit (—)§	126	142	47	175	123‡

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 February 23.
§ Not reflected in data above.

[1] For details of the refunding, see this *Review* (February 1972), page 36.

serves. Against this background, bank buying continued to reduce the floating supply of recent Treasury coupon issues and prices moved irregularly higher. By the end of the month, yields on most intermediate-term issues were 1 to 23 basis points lower than at the end of January, and yields on long-term bonds were generally 4 to 12 basis points lower.

Interest rate movements in the Treasury bill market in the early part of February reflected mainly the ready availability of reserves and the reluctance of investors to commit themselves to issues with longer maturities and a greater risk of price fluctuation. Broad demand developed for short maturities and, as the tradable supply of these issues declined and yield spreads widened further, buying interest spilled over into the six-month range. At the time the refunding results were published, the absence of an announcement of a widely expected Treasury financing in the bill sector led to some professional demand for bills for trading purposes. Against this backdrop, the weekly auction held on February 7 attracted fairly strong interest and resulted in average issuing rates on the new three- and six-month issues of 3.141 percent and 3.594 percent, respectively (see Table II), down about 23 and 14 basis points from the previous week.

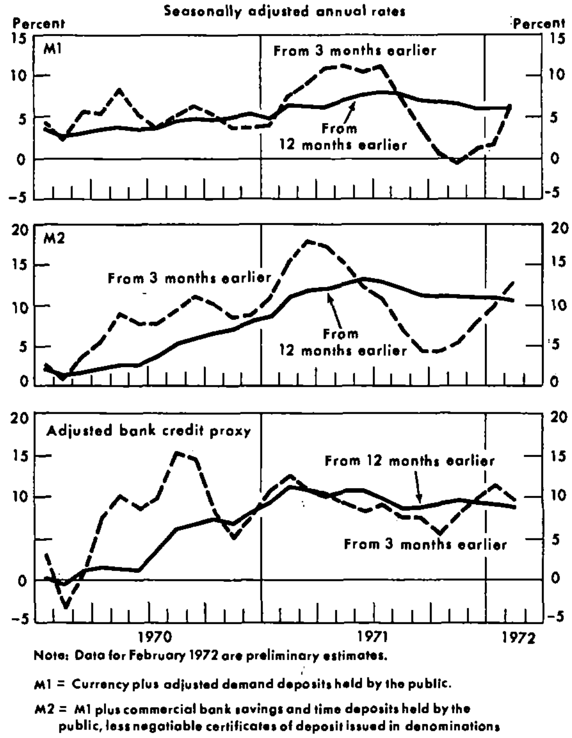
After the close of trading on February 8, the Treasury announced that it would augment its weekly bill auctions by additions of $100 million and $200 million to the offerings of three- and six-month bills, respectively, beginning with the February 14 auction. Given the market's anticipation of a bill sale, this announcement had only a temporary weakening effect on rates. Treasury bill rates soon resumed their downward trend, as sustained demand pressed against a relatively thin available supply. At the auction held on February 14, bidding was somewhat cautious for the larger quantity of bills at the prevailing lower rates. Rates on the new three- and six-month bills, respectively, fell to 3.066 percent (the lowest such rate in over eight years) and 3.537 percent, thereby widening the spread between the three- and six-month issues to an exceptionally large 47 basis points. By comparison, the rate spread in the auction held seven weeks earlier had been 22 basis points. Even more dramatic was the rate advantage of the twelve-month bills over the three-month bills, which widened to almost a full percentage point by mid-February (see Chart II).

Treasury bill rates rose in the last half of the month, as both the Federal Reserve and the Treasury added to the market supply of bills. The Federal Reserve sold outright or redeemed $1.8 billion of bills over the two statement weeks ended March 1, thus absorbing reserves released by the Treasury's reduction of its balances at the Reserve Banks. On Thursday, February 24, the Treasury announced that it would auction on March 1 for settlement on March 6 a $3 billion "strip" of bills consisting of $200 million additions to each of the fifteen outstanding weekly Treasury bill series maturing from March 30 through July 6. These large-scale additions to future bill supplies more than outweighed the sizable foreign demand for bills that reflected a renewed flow of dollars abroad. There was also concern that the Federal Reserve might soon begin to promote somewhat greater firmness in the money market in view of the strength appearing in the narrow money supply (M_1). At the month's end, the three-month bill rate was bid at 3.46 percent, up 47 basis points from the month's low of 2.99 percent and up 11 basis points over the month. Moreover, the rates on six- and twelve-month bills closed the month at 3.78 percent and 4.18 percent, respectively, narrowing somewhat the yield spreads that had existed in the Treasury bill market at midmonth.

Chart I

CHANGES IN MONETARY AND CREDIT AGGREGATES

Seasonally adjusted annual rates



Note: Data for February 1972 are preliminary estimates.

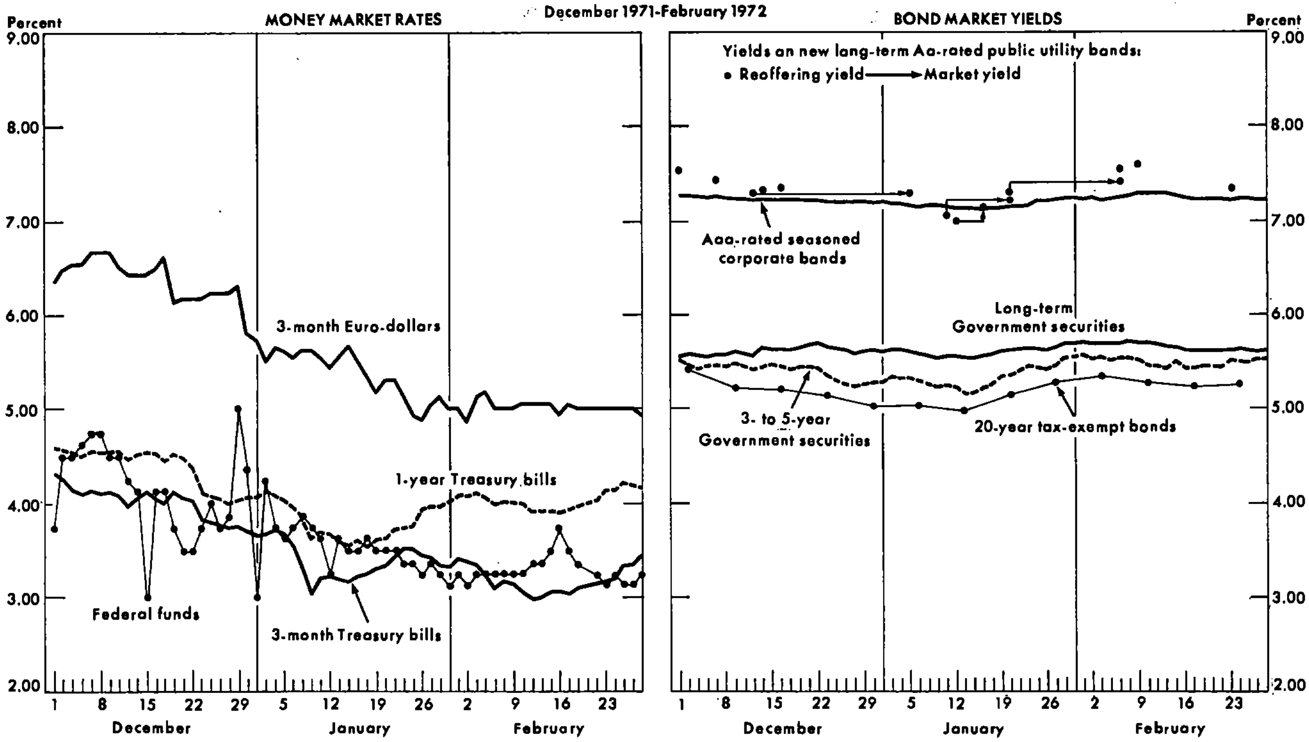
M1 = Currency plus adjusted demand deposits held by the public.

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.

Chart II
SELECTED INTEREST RATES
December 1971-February 1972



Note: Data are shown for business days only.

MONEY MARKET RATES QUOTED: Bid rates for three-month Euro-dollars in London; 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 and one-year 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 year 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.*

OTHER SECURITIES MARKETS

The gloomy atmosphere that had pervaded the corporate bond market in the last half of January extended into the early part of February. The poor reception accorded an $80 million A-rated utility issue early in the month added to the heavy inventory positions of dealers and encouraged investors to remain on the sidelines. On February 7, several newly issued corporate bonds were released from syndicate price restrictions and traded at yields generally 11 to 13 basis points above their offering rates. That same day, investor appetite for a $75 million Aa-rated utility issue was lackluster even though this issue was priced to yield 7.55 percent, 5 basis points higher than the offering yield on the A-rated utility marketed just four days earlier.

The tone of the market improved considerably, however, when on February 8 a $40 million Aaa-rated utility bond issue was marketed to yield 7.40 percent, 40 basis points above the yield on the last comparable utility offering about one month earlier. The issue sold well, leading underwriters to believe that yields had reached sustainable levels. Thereafter, some aggressively priced issues were brought to market. A $200 million offering of Aa-rated oil company debentures encountered a cool investor response when offered at a 7.25 percent yield on February 10. However, when freed to trade in the open market after the weekend, this issue rose to a one point premium as it benefited from the improving tone of the market. Nonetheless, the pricing of an Aaa-rated Bell System offering proved too aggressive and the issue faced slow initial sales. The two-part $250 million offering auctioned on February 15 consisted of $175 million of 7¼ percent debentures due in 2008 and $75 million of 6⅝ percent notes due in 1979. The debentures were priced to yield 7.23 percent, 7 basis points below the yield on a similar long-term Bell System issue sold three weeks earlier. Moreover, the notes were priced to yield 6.50 percent, 40 basis points below the yield on similar Bell System notes sold two weeks earlier. The aggressive pricing of both the new notes and bonds—less than 40 percent of the combined offering was sold initially—made issues trading in the secondary market appear attractive and inspired a rally in that area. Over the remainder of the month, a cautious atmosphere reemerged and prices in the corporate bond market drifted lower. On February 23, an Aa-rated $50 million utility issue was priced to yield 7.35 percent in thirty years, 20 basis points below the yield on the comparable issue sold two weeks earlier. Despite the light calendar of utility offerings at the end of the month, this issue generated only limited demand.

Table II

AVERAGE ISSUING RATES*
AT REGULAR TREASURY BILL AUCTIONS

In percent

Maturities	Weekly auction dates—February 1972			
	Feb. 7	Feb. 14	Feb. 18	Feb. 28
Three-month	3.141	3.066	3.145	3.446
Six-month	3.594	3.537	3.513	3.762
	Monthly auction dates—December 1971-February 1972			
	Dec. 28	Jan. 25	Feb. 22	
Nine-month	3.930	3.892	3.862	
One-year	3.927	3.936	4.091	

*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.

Prices in the tax-exempt sector generally responded in a more restrained fashion to the same factors that affected the corporate market. On February 9, the Port of New York Authority offered $150 million of term revenue bonds. The A-rated 5.80 percent bonds, priced to yield 5.90 percent in thirty-five years, encountered a cool reception. After price restrictions were removed from the $120 million unsold balance of this issue, trading began at 10 basis points above the offering yield. Investor responses to other offerings around midmonth were mixed, and over the remainder of the month prices of issues trading in the secondary market fluctuated narrowly, moving slightly lower on balance. However, the terms of the New York State Housing Finance Agency's $175 million A-rated serial bonds proved attractive to investors when offered on February 24, and this issue sold out quickly. Thirty-year maturities were priced to yield 6⅜ percent, about 50 basis points above yields on the same maturities of this agency's issue sold last November. The Blue List of dealers' advertised inventories, which had dropped by $150 million over the first third of February, rose again and closed the month at $779 million, about $100 million below its level at the beginning of the month. *The Weekly Bond Buyer's* twenty-bond index of municipal bond yields closed at 5.28 percent, just 1 basis point below its level at the beginning of the month.