The Money and Bond Markets in May

On the whole, interest rates declined during May as estimates of near-term demands on the capital markets were revised downward. There was a tendency for rates to rise early in the month, as market participants became concerned over the intensification of military activity by the North Vietnamese. Additional indications of domestic economic expansion also contributed to investor caution. The announcement by President Nixon of the mining of North Vietnamese harbors brought some temporary price declines. Following news of the relatively small rise in consumer prices during April and the carrying forward of plans for President Nixon's trip to Russia, however, the markets developed a firmer tone and rates moved lower during the last two weeks in May. The major exception was the bill market where rates moved back into closer alignment with the Federal funds rate.

In contrast to the bill sector, prices of Treasury coupon issues rose on balance during May. Some reinvestment demand for coupon issues arose from holders of the maturing May notes.[1] More importantly, banks and others were also encouraged by continuing evidence that the Treasury's strong cash position would reduce near-term borrowing. (On May 31, the Treasury confirmed that it would pay off in cash, rather than refund, the $1.23 billion of its bonds maturing June 15.) Trading activity in the corporate and tax-exempt market was rather dull during much of May. The relatively small volume of new issues prompted strong underwriter bidding, but investor resistance developed to the pricing on some of those bonds. In the final part of the month, however, investor demand picked up and interest rates declined. The Bond Buyer index of yields on twenty municipal bonds closed at 5.15 percent on June 1, down 5 basis points since April 27 and 24 basis points below its high for the month of 5.39 percent.

THE MONEY MARKET

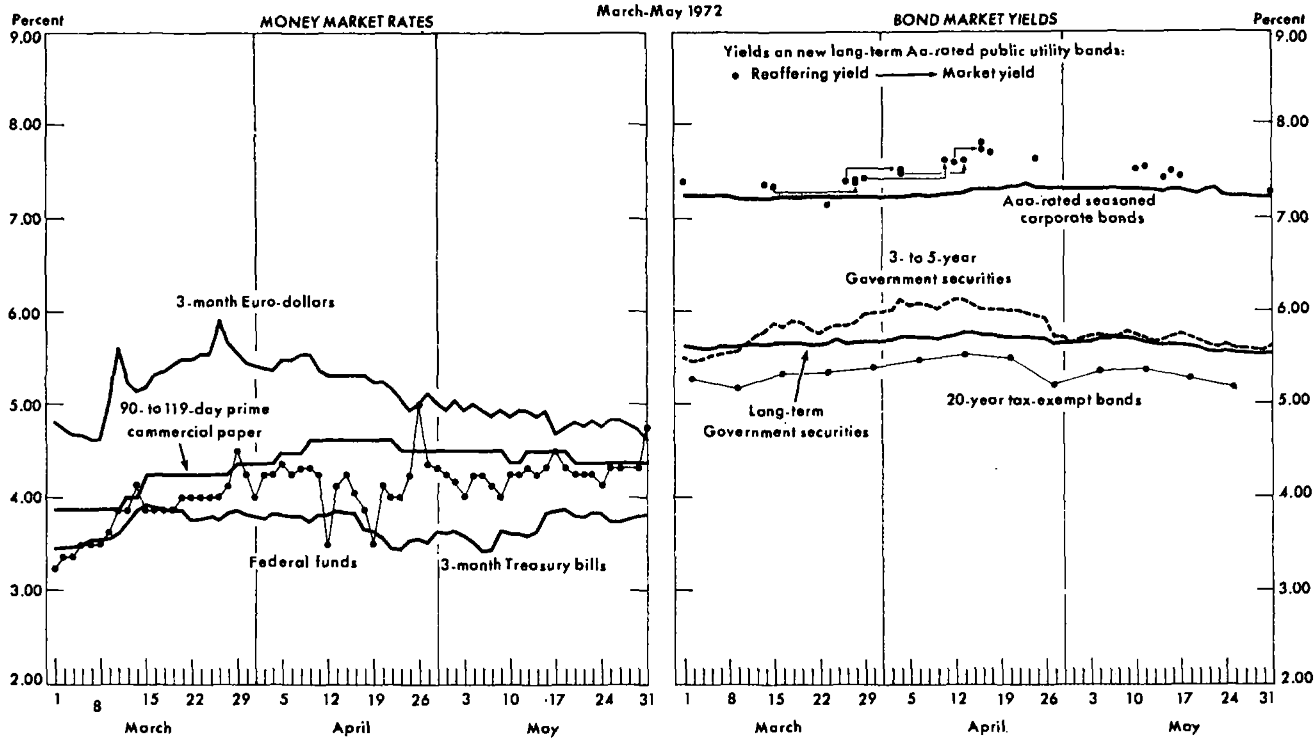
Rates on most short-term instruments were either unchanged or declined slightly during May (see Chart I). The return on various maturities of directly placed prime commercial paper was unchanged to ⅛ percentage point lower, while yields on dealer-placed paper were ⅛ to ¼ percentage point lower for the month. Offering rates on new negotiable certificates of deposit (CDs) declined by about ⅛ percentage point. In addition, several banks lowered their prime rate early in the month, and two of the banks with "floating" rates lowered them to the generally prevailing 5 percent level at the end of the period.

Federal funds traded generally within the same range of rates which had prevailed in April, closing the month on a firm note. The effective rate averaged 4.27 percent in May, 10 basis points higher than a month earlier. Member bank borrowings at the Federal Reserve averaged $112 million in the five weeks ended May 31 (see Table I), little changed from the average borrowings in April. Banks typically borrowed very little on the first six days of each week in May, but then resorted to the window to cover reserve requirements on each settlement day. By far the bulk of these borrowings was concentrated at the major New York City banks until May 31, when other reserve city banks borrowed heavily. According to preliminary data, total member bank reserves grew at a seasonally adjusted annual rate of about 8 percent in May, while "reserves available to support private nonbank deposits" (RPD) grew at about a 7½ percent annual rate. RPD consists of total member bank reserves except those required to support United States Government and interbank deposits. At its January 11 meeting the Federal Open Market Committee,[2] noting that the fourth-quarter

[1] For details of the Treasury's refinancing, which partially refunded the notes maturing May 15, see this *Review* (May 1972), page 124.

[2] For a more detailed discussion of the January 11 meeting, see "Record of Policy Actions of the Federal Open Market Committee", *Federal Reserve Bulletin* (April 1972), pages 390-97.

Chart I
SELECTED INTEREST RATES
March-May 1972



Note: Data are shown for business days only.

MONEY MARKET RATES QUOTED: Bid rates for three-month Euro-dollars in London; offering rates (quoted in terms of rate of discount) on 90- to 119-day prime commercial paper quoted by three of the four dealers that report their rates, or the midpoint of the range quoted if no consensus is available; 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 underwritting 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 Bond Buyer.

sluggishness in the growth of the money supply had been accompanied by little growth in total member bank reserves, decided that more attention should be given to the provision of sufficient reserves to support a more rapid rate of monetary growth. Initially, the Committee decided that open market operations, while continuing to take appropriate account of money market conditions, should be guided more by the course of total bank reserves than had been customary previously. At its February 15 meeting,[3] the Committee decided to express its reserve objectives in terms of reserves available to support private nonbank deposits (see Chart II). This measure was considered preferable to total reserves because the latter aggregate is affected by short-run fluctuations in Government and interbank deposits which are sometimes large and difficult to predict. In effect, it was deemed appropriate for System open market operations normally to provide or absorb the reserves needed to accommodate changes in Government and interbank deposits without disturbing reserves available to support private nonbank deposits. The Committee decided, however, that in pursuing the reserve target the System should avoid both sharp short-run fluctuations and undesirably large cumulative changes in money market conditions in either direction

[3] *Federal Reserve Bulletin* (May 1972), pages 455-63.

between Committee meetings, which are usually held at four-week intervals.

Based on preliminary data, there was some further deceleration in the growth of M_1—demand deposits adjusted and currency held by the public—during May when the demand deposit component grew less rapidly than it had in April. It is now estimated that M_1 grew at a seasonally adjusted annual rate of 2.2 percent over the four weeks ended May 24[4] and at a 7.6 percent rate during the thirteen weeks ended then. For the twenty-six weeks ended May 24, a somewhat more useful period since the monetary aggregates exhibit a good deal of short-run volatility, M_1 has grown at a seasonally adjusted annual rate of 6.9 percent, up from the 6.2 percent rate of growth for all of 1971.

Data for the four weeks ended May 24 indicate that M_2, which is composed of M_1 plus commercial bank time and savings deposits other than large negotiable CDs, grew at a seasonally adjusted annual rate of 7.8 percent. These consumer-type time and savings deposits make up almost one half of the broader money supply total, and their rapid increase of some 13 percent to a large extent offset the slower pace at which M_1 grew during the month. It is estimated that M_2 increased at annual rates of 9.4 percent over the thirteen weeks ended May 24 and 11.1 percent over the twenty-six weeks ended then.

In contrast to the money supply measures, the adjusted bank credit proxy experienced some quickening in its rate of growth during May to a seasonally adjusted annual pace of 15.2 percent over the first four statement weeks, compared with 13.3 percent over the preceding four. While the substantial increase in time deposits was the primary factor in the accelerated growth of the proxy in May, an additional element of strength in recent months has been the relatively strong performance of United States Government deposits, compared with earlier years. As the Treasury confirmed when announcing the terms of the May refinancing, its cash position has been extremely strong as a result of higher revenues and lower expenditures than had been anticipated, and this has been reflected in the unusually large Government deposit balances at member banks. In large part, because of the substantial gains in total time and Government deposits in recent months, the adjusted credit proxy grew by a seasonally adjusted annual rate of 15.4 percent over the thirteen weeks ended May 24, a decidedly more rapid pace than that of M_1 or M_2. Proxy

Table I

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

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

Factors	Changes in daily averages— week ended					Net changes
	May 3	May 10	May 17	May 24	May 31	
"Market" factors						
Member bank required reserves	— 259	+ 58	— 347	+ 438	— 173	— 283
Operating transactions (subtotal)	+ 287	— 293	+ 847	— 260	— 321	+ 260
Federal Reserve float	— 110	+ 192	+ 27	+ 187	— 405	— 109
Treasury operations*	+ 336	— 756	+ 763	— 105	+ 95	+ 333
Gold and foreign account	— 39	+ 407	+ 466	— 9	— 174	+ 651
Currency outside banks	+ 188	— 219	— 501	— 291	+ 250	— 573
Other Federal Reserve liabilities and capital	— 88	+ 82	+ 93	— 42	— 86	— 41
Total "market" factors	+ 28	— 235	+ 500	+ 178	— 494	— 23
Direct Federal Reserve credit transactions						
Open market operations (subtotal)	+ 3	+ 192	— 184	— 44	+ 234	+ 201
Outright holdings:						
Treasury securities	+ 182	+ 187	— 176	— 45	+ 64	+ 212
Bankers' acceptances	—	+ 5	— 8	+ 1	— 2	— 4
Federal agency obligations	+ 25	—	—	—	—	+ 25
Repurchase agreements:						
Treasury securities	— 184	—	—	—	+ 159	— 25
Bankers' acceptances	— 17	—	—	—	+ 9	— 8
Federal agency obligations	— 3	—	—	—	+ 4	+ 1
Member bank borrowings	— 162	— 30	— 48	+ 24	+ 191	— 25
Other Federal Reserve assets†	+ 49	+ 41	— 167	— 216	+ 55	— 238
Total	— 110	+ 203	— 399	— 235	+ 478	— 63
Excess reserves	— 87	— 27	+ 101	— 56	— 16	— 85

	Daily average levels					Monthly averages
Member bank:						
Total reserves, including vault cash	32,838	32,753	33,201	32,707	32,864	32,872‡
Required reserves	32,707	32,649	32,996	32,558	32,731	32,728‡
Excess reserves	131	104	205	149	133	144‡
Borrowings	117	87	39	63	254	112‡
Free, or net borrowed (—), reserves	14	17	166	86	— 121	32‡
Nonborrowed reserves	32,721	32,666	33,162	32,644	32,610	32,761‡
Net carry-over, excess or deficit (—)§	85	72	111	95	79	88‡

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 May 31.
§ Not reflected in data above.

[4] The growth rate cited is the annualized percentage change of the average level of M_1 in the four weeks ended May 24 from the average of the four weeks ended April 26. Similarly, the growth rates cited for longer periods are based on the average levels in the four weeks ended thirteen, twenty-six, and fifty-two weeks, respectively, prior to the four-week period ended May 24.

growth in the twenty-six weeks ended May 24 was at a 12.6 percent seasonally adjusted annual rate and at a 10.5 percent rate during the fifty-two weeks ended then.

THE GOVERNMENT SECURITIES MARKET

Rates on Treasury bills, unlike those on most other instruments, rose on balance during May. At the beginning of the month, however, a firm tone was evident in the bill market as participants continued to respond favorably to the Treasury's statements concerning the May refinancing which were made at the end of April. The Treasury's very strong cash position indicated that no additional funds would be raised in the bill market over the near term, and its planned redemption of $700 million of the notes maturing in May fostered the expectation of a sizable amount of reinvestment demand for bills. There was good investor interest in the bill market at the start of May, and fairly persistent demand emerged for the rather thin floating supply of bills. Rates on most bills declined by 1 to 19 basis points during the first week of May and, with their inventories relatively depleted, dealers were fairly aggressive bidders in the weekly auction on May 8. The average issuing rates on the new three- and six-month bills at that auction were 14 and 9 basis points lower, respectively, than a week earlier (see Table II).

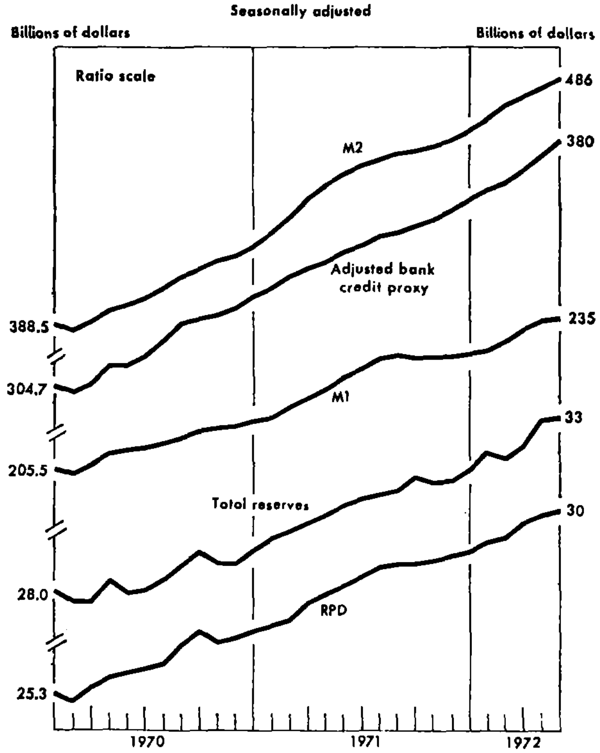
Following President Nixon's speech regarding the mining of North Vietnamese harbors and the interdiction of their supply routes, rates moved higher when the market opened on May 9 but then began to stabilize as no substantial investor selling developed. Over the next several days, the bill market deteriorated further in quiet, largely professional trading and an air of caution emerged in response to sales of bills on several days by the Trading Desk of the Federal Reserve Bank of New York. The reinvestment demand from the Treasury notes which matured at midmonth proved considerably less than had been anticipated, and bill rates continued on an upward path. Already uncomfortable in the face of the abundant supply of bills for which there was little demand, dealers became apprehensive about the final full week of the month when three auctions were scheduled because of the holiday on Monday, May 29. Reflecting this atmosphere, average issuing rates on the new three- and six-month bills moved higher in the weekly auction on Monday, May 22, by 13 and 12 basis points, respectively, while the rates set on the new nine- and twelve-month bills the next day rose 13 and 10 basis points from their April levels. The tone of the market began to firm, however, in response to some renewed demand from both investors and dealers, and rates moved lower over the remainder of the month. In the final weekly auction on Friday, May 26, the average issuing rates on the new three- and six-month bills declined by 6 and 13 basis points, respectively, from those of the preceding Monday. Rates on outstanding bills maturing within three months were generally 15 to 25 basis points higher over the month as a whole, while rates on longer maturities were generally 1 to 15 basis points higher.

Yields on most Treasury coupon issues moved in the opposite pattern from those on Treasury bills during much of May, rising early in the month and then falling steadily over the rest of the period. Interest in the May 2 auction of notes and bonds proved less aggressive than had been expected as a result of concern over the possibility of

Chart II

MONETARY AND RESERVE AGGREGATES

Seasonally adjusted



Note: Data for May 1972 are averages of the four weeks ended May 31 for total reserves and RPD and averages of the four weeks ended May 24 for the other aggregates.

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.

RPD = Total member bank reserves less those required to support United States Government and interbank deposits.

Source: Board of Governors of the Federal Reserve System.

increased demands on the capital markets which could result from the economic expansion and reports of a substantial buildup in Vietnamese military activity. Prices of outstanding issues edged downward over the next few days and then fell in initial reaction to President Nixon's May 8 speech.

In the absence of investor selling, however, the market soon stabilized and then prices began to rise as the reaction from other nations to the Vietnam initiatives proved less negative than many had feared. The atmosphere was also buoyed by the strong technical position of the market and by some reinvestment demand on the part of holders of the maturing May notes. The announcement of the relatively modest rise in consumer prices again in April helped to strengthen the market by dampening inflationary expectations. Market reports of an increasingly strong Treasury cash position were also a favorable influence. Although activity was largely professional after midmonth, the market maintained a firm tone and prices continued to rise. For the month as a whole, most Treasury coupon issues registered declines in yields of 3 to 22 basis points.

Table II

AVERAGE ISSUING RATES*
AT REGULAR TREASURY BILL AUCTIONS

In percent

Maturities	Weekly auction dates—May 1972				
	May 1	May 8	May 15	May 22	May 26
Three-month	3.604	3.462	3.699	3.825	3.762
Six-month	3.998	3.907	4.118	4.233	4.106

Maturities	Monthly auction dates—March-May 1972		
	March 24	April 25	May 23
Nine-month	4.511	4.234	4.367
One-year	4.661	4.362	4.465

* 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.

OTHER SECURITIES MARKETS

The month's principal corporate flotation—$250 million of Aaa-rated Bell Telephone System debt—was made on May 2. Considered by many as a key test of the viability of the current interest rate levels, the offering consisted of $175 million of forty-year debentures yielding 7.40 percent and $75 million of seven-year notes priced to yield 6.60 percent. Neither part of the offering was particularly successful, though the notes were somewhat more in demand, and the cool reception to the offering signaled a pause in the rally which had begun in mid-April. The lack of institutional investor interest in the offering was interpreted by some participants as an indication that lower bond prices were expected in the immediate future. This dampened the market tone further, and rates on seasoned corporate bonds also moved higher over the next few days amid concern over the stepped-up level of military activity in Vietnam. Then prices fell sharply in response to the President's television address on the evening of May 8 but quickly rebounded.

In contrast to the fate of the Bell System offering, a $100 million issue of Aaa-rated industrial bonds was enthusiastically received on May 11. The fact that very few industrial corporations enjoy such a high rating gave the bonds substantial scarcity value, and investors were eager to buy them despite their relatively low yield of 7.08 percent. During the following week, several medium-sized Aa-rated utility issues were marketed with mixed receptions at yields ranging from 7.43 percent to 7.55 percent. Another pair of Aaa-rated telephone issues was brought to market on May 22. The $50 million issue of forty-year debentures was priced to yield 7.34 percent, 6 basis points less than the yield offered on the earlier Bell System issue on May 2 and the lowest yield placed on such an issue since mid-February. The companion offering of six-year notes was priced to yield 6.50 percent. This aggressive pricing resulted in rather slow initial sales of these issues, but prompted swift sales of older securities still in syndicate hands and in the secondary market where yields looked attractive in comparison. As prices of issues in the secondary market were bid up, in turn, sales of the new telephone issues improved. Corporate bond prices closed higher for the month, although some investor resistance developed on May 31 to an offering of thirty-year Aa-rated utility bonds priced to yield 7.29 percent, the lowest yield offered on such an issue since mid-January.

In the tax-exempt bond market, a $100 million offering of Pennsylvania bonds was marketed on May 2. Providing yields that were described as somewhat less attractive than had been anticipated, the bonds were only about 20 percent sold at the close of the first day. When the remaining balance was released from price restrictions two days later, yields adjusted upward by as much as 20 basis points. This cleared the atmosphere in the market, and a number of new issues—including a $200 million offering of Battery Park City Authority (New York) bonds—were well received by investors during the next few days at somewhat higher yields than those prevailing at the beginning of the month.

A cautious tone developed on the day following the President's speech, and an issue of New Jersey bonds was postponed because of the uncertain market conditions. Other scheduled offerings were marketed that day, though at somewhat lower prices than originally intended, and investor reaction was generally quite favorable. Prices rose over the next several days, and the postponed New Jersey bonds were almost a first day sellout at the price set on them a week earlier. Prices continued to rise as the month progressed, and The Bond Buyer index of yields on twenty municipal bonds fell by 10 basis points to 5.29 percent in the week ended May 18 after increasing by 19 basis points over the two preceding weeks. The index fell further to 5.19 percent on May 25 and to 5.15 percent on June 1. This was the lowest level since January 13, 1972.