The Money and Bond Markets in June

Most interest rates resumed their upward course in June shortly after the beginning of the month as an initially optimistic mood was dispelled. Although some market observers hoped that interest rates had peaked, others felt that inflationary expectations had yet to be fully incorporated in current interest rates and that pressures on the credit markets would continue. Inflationary forces were confirmed by the incoming price statistics, and upward movement in the Federal funds rate along with reports of heavy bank borrowing by businesses seemed to support the latter view. Consequently, yields resumed their climb. Several short-term rates set new records, among them the prevailing prime rate, which reached 11¾ percent by the month end.

The corporate and municipal bond markets sagged as a number of medium-grade new issues sold slowly. Investors continued to reevaluate the implications for the utility industry of higher energy prices and inflation. Generously priced intermediate-term issues sold well, but investors were wary of longer term offerings. Near the end of the month, a record yield was set on a telephone issue, although most yields remained a touch below the highs reached in 1970.

In contrast, Treasury obligations proved to be in demand, and rates on short-term bills experienced net declines during the month. Among the factors buoying demand were large purchases by foreign central banks, the absence of default risk attached to Treasury issues, and reports that the oil-exporting nations might be investing some of their funds in Treasury securities. Technical factors also supported the market since the increased demand came at a time when dealers' inventories were unusually low.

Growth in the monetary aggregates speeded up again in June after slowing in May. Both M_1—private demand deposits adjusted plus currency outside commercial banks—and M_2—which also includes time deposits other than large negotiable certificates of deposit (CDs)—grew more rapidly in the four weeks ended June 26 than they had in May. The growth of large CDs, while still rapid, slowed from the explosive pace of the previous two months.

THE MONEY MARKET, BANK RESERVES, AND THE MONETARY AGGREGATES

Rates on most money market instruments held steady in the early part of June but soon resumed their upward course (see Chart I). The effective rate on Federal funds advanced to a new record and averaged 11.93 percent for the month, up 62 basis points from the previous record level set in May. Dealers raised their offering rates on prime commercial paper by a net 1¼ to 1½ percentage points over the month, establishing a rate of 12 percent on 30- to 119-day paper and 11⅞ percent on longer term paper. Secondary market rates on large negotiable CDs dropped early in the month but climbed sharply thereafter to around 12⅛ percent for three-month maturities, a 110 basis point gain for the month.

Business demand for loans, which had shown signs of slackening in May, burgeoned again in the second week of June and was also strong over the June 15 tax date. Consequently, the move by a handful of banks in the first week to reduce the prime rate from 11½ percent to 11¼ percent was not followed by other banks. By the third week, most of those banks had returned to an 11½ percent prime rate. On June 24 a few banks lifted the prime rate to 11¾ percent, and by the end of the month most other banks had followed suit.

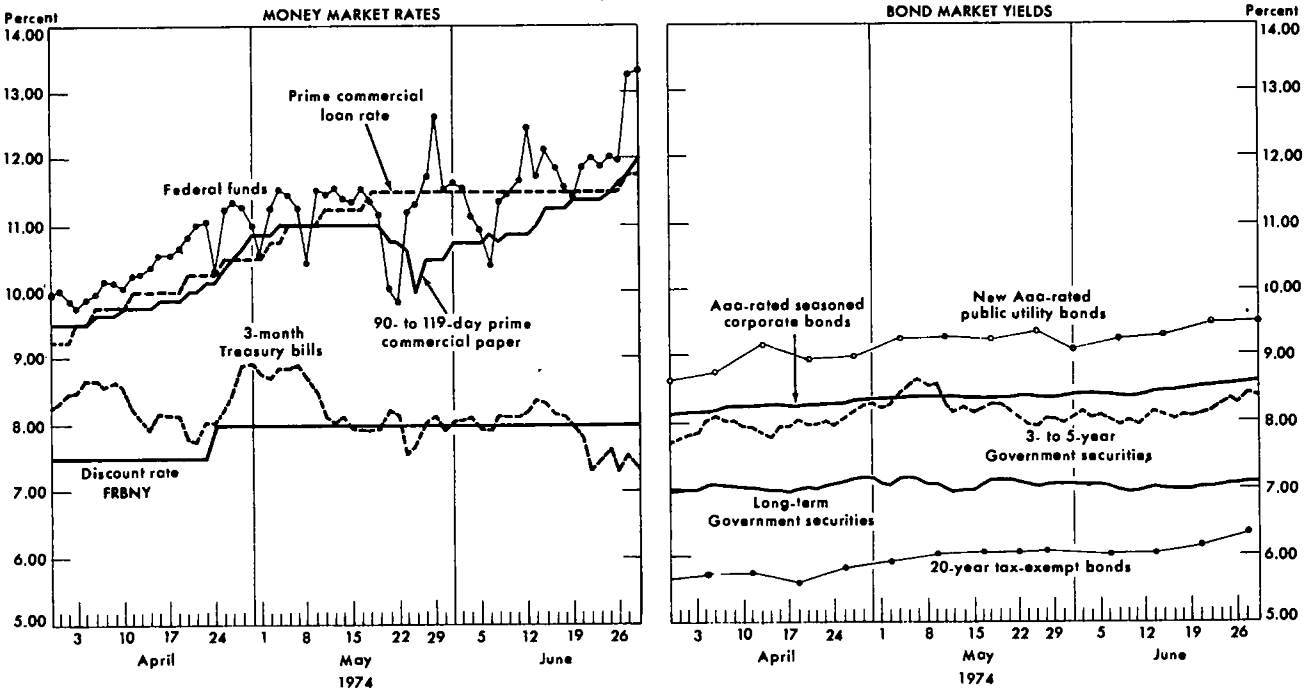
In the face of strong credit demands and money market pressures, member banks were again heavy borrowers from the Federal Reserve. Average borrowings for the month were $2,949 million (see Table I), the highest monthly average ever. Part of this again reflected substantial lending to Franklin National Bank, although the bank was able to reduce somewhat its borrowing from the System after it arranged to buy up to $250 million of Federal funds on a secured basis from Clearing House banks in New York and certain other banks.

According to preliminary data, the monetary aggregates advanced at a rapid pace in June after having grown moderately in May. For the four weeks ended June 26, M_1 grew at an 8.4 percent seasonally adjusted annual rate relative to its average of the last four weeks in May. In

Chart I

SELECTED INTEREST RATES

April - June 1974



Note: Data are shown for business days only.

MONEY MARKET RATES QUOTED: Prime commercial loan rate at most major banks; offering rates (quoted in terms of rate of discount) on 90- to 119-day prime commercial paper quoted by three of the five 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 Aaa-rated public utility bonds are based on prices asked by underwriting syndicates, adjusted to make them equivalent to a standard Aaa-rated bond of at least twenty years' maturity; 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, Inc., and The Bond Buyer.

comparison to the four-week average of a year earlier, M_1 grew 5.8 percent in the four weeks ended June 26 (see Chart II). The acceleration in the growth of M_2, to an estimated 10.5 percent rate for the four weeks ended June 26 relative to the average of the four previous weeks, reflected a bulge in the time deposit component at the beginning of June following some sluggishness in May. Average time deposit growth over the eight-week period ended in late June was close to the pace of expansion of the preceding two months. Large negotiable CDs grew at an estimated 28.8 percent rate in the four weeks ended June 26, compared with the explosive 120 percent seasonally adjusted annual rate in the previous two months. Consequently, growth of the adjusted bank credit proxy moderated somewhat in June, but its growth rate from thirteen weeks earlier was an unusually strong 20.9 percent.

THE GOVERNMENT SECURITIES MARKET

Prices of Treasury securities moved irregularly during June, with the strongest performances being shown by the shorter maturity issues. At times the inflationary worries that were contributing to upward movements in other interest rates also put pressure on Treasury securities. For the most part, however, the Treasury sector was shielded from these forces, as investors showed a strong preference for Treasury obligations—particularly bills—over other market instruments.

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, JUNE 1974

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

Factors	Changes in daily averages— week ended				Net changes
	June 5	June 12	June 19	June 26	
"Market" factors					
Member bank required reserves	+ 100	+ 396	— 793	+ 38	— 259
Operating transactions (subtotal)	+ 467	+1,716	—1,463	— 650	+ 70
Federal Reserve float	+ 406	— 160	+ 133	— 110	+ 269
Treasury operations*	+ 394	+1,895	— 571	—1,143	+ 575
Gold and foreign account	— 112	+ 90	— 683	+ 649	— 56
Currency outside banks	— 235	— 363	— 242	+ 91	— 749
Other Federal Reserve liabilities and capital	+ 14	+ 254	— 99	— 137	+ 32
Total "market" factors	+ 567	+2,112	—2,256	— 612	— 189
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	— 24	—1,890	+1,828	+ 825	+ 739
Outright holdings:					
Treasury securities	— 279	—1,283	+1,510	— 234	— 286
Bankers' acceptances	— 1	— 1	— 2	+ 1	— 3
Federal agency obligations	— 11	— 31	— 41	—	— 83
Repurchase agreements:					
Treasury securities	+ 66	— 277	+ 261	+ 617	+ 667
Bankers' acceptances	+ 64	— 81	+ 80	+ 26	+ 89
Federal agency obligations	+ 137	— 217	+ 20	+ 415	+ 355
Member bank borrowings	— 549	— 325	+ 494	— 435	— 815
Seasonal borrowings†	+ 17	+ 5	+ 6	— 9	+ 19
Other Federal Reserve assets‡	+ 112	+ 23	+ 59	+ 67	+ 261
Total	— 461	—2,193	+2,381	+ 458	+ 185
Excess reserves‡	+ 106	— 81	+ 125	— 154	— 4

	Daily average levels				Monthly averages§
Member bank					
Total reserves, including vault cash‡	36,280	35,083	36,721	36,529	36,153
Required reserves	36,066	35,670	36,463	36,425	36,156
Excess reserves	214	133	258	104	177
Total borrowings	3,054	2,729	3,223	2,788	2,049
Seasonal borrowings†	131	136	142	133	136
Nonborrowed reserves	33,226	32,354	33,498	33,741	33,205
Net carry-over, excess or deficit (—)‖	95	104	63	78	85

Note: Because of rounding, figures do not necessarily add to totals.
* Includes changes in Treasury currency and cash.
† Included in total member bank borrowings.
‡ Includes assets denominated in foreign currencies.
§ Average for four weeks ended June 26, 1974.
‖ Not reflected in data above.

In the Treasury bill market, rates moved irregularly higher in the first two weeks of June, and then shorter rates plunged in the third week. Rates on most issues due within six months fell 22 to 62 basis points that week, with the three-month bill rate falling by more than 100 basis points to 7.30 percent. In the final week of the month, many participants became concerned that the declines had been exaggerated, but rate increases attracted buyers and were quickly reversed. By the end of June, rates on longer term bills were 2 basis points below to 22 basis points above their month-earlier levels, while rates on bills maturing within six months were 6 to 77 basis points lower. In the last half of June, the three-month bill rate averaged more than 4 percentage points below rates available on CDs or commercial paper of the same maturity. This is considerably greater than the normal spread between these instruments, which averaged less than 1½ percentage points in 1973.

A substantial portion of the demand for bills came from foreign central banks. Marketable debt held by the Federal Reserve in custody for official foreigners increased by a net $1,206 million between May 29 and June 26. Some of this demand came from one country, which was restructuring its Treasury debt holdings to achieve a better balance. To this end, it began bidding for $200 million of new Treasury bills each week for ten weeks, beginning with the June 17 auction, to replace special nonmarketable issues. To accommodate this restructuring, the Treasury continued to offer approximately $4.5 billion of bills in that and succeeding auctions to replace $4.3 billion of maturing bills. Other factors which contributed to the strength in demand for bills were the reinvestment of the proceeds from the maturing June tax anticipation bills, less than 20 percent of which was used to pay taxes, and the continued large orders from individuals who found the yields more attractive than those on alternative investments available in denominations of less than $10,000.

In the regular weekly auction held June 3, bidding interest was routine and average issuing rates of 8.300 and 8.426 percent, respectively, were established on the three- and six-month bills (see Table II). In the next two auctions, rates were pushed lower and dealers bid aggressively as they sought to replenish their depleted inventories in the face of continued evidence of investor demand. By June 24, participants had become concerned that rates had been pushed too low in the previous few days and cautious bidding led to rates that were above pre-weekend levels but still below those of a week earlier. In the monthly auction of 52-week bills held June 26, bidding interest was restrained and the average issuing rate of 8.256 percent was somewhat above rates on outstanding issues.

The market for Treasury coupon issues initially benefited from the optimistic view expressed by several market observers that interest rates might be near their peaks. Successful sales of corporate and Federal agency bonds were interpreted as an encouraging sign. By midmonth, however, participants became more cautious in the face of renewed strength in credit demand and a large increase in the wholesale price index in May. Subsequent price declines erased earlier gains. Yields on most intermediate-maturity issues were 7 basis points lower to 38 basis points higher, on balance, for the month. Yields on longer term issues moved narrowly and were 2 basis points lower to 9 basis points higher.

Prices of Federal agency issues also moved in a relatively narrow range. On June 6, the Federal Home Loan Banks sold $1.5 billion of bonds to raise new cash. The offering consisted of $400 million of 8.70 percent bonds due February 25, 1976, $500 million of 8.70 percent bonds due May 25, 1977, and $600 million of 8.65 percent bonds due February 26, 1979. The issues were well received. The six-month bonds offered June 19 by the Banks for Cooperatives sold slowly despite a 9¼ percent yield, considerably above Treasury issues of similar maturity. A better reception was accorded the Federal Intermediate Credit Banks' nine-month 9¼ percent bonds and 33-month 8.70 percent bonds which were marketed at the same time.

Table II

AVERAGE ISSUING RATES AT REGULAR TREASURY BILL AUCTIONS*

In percent

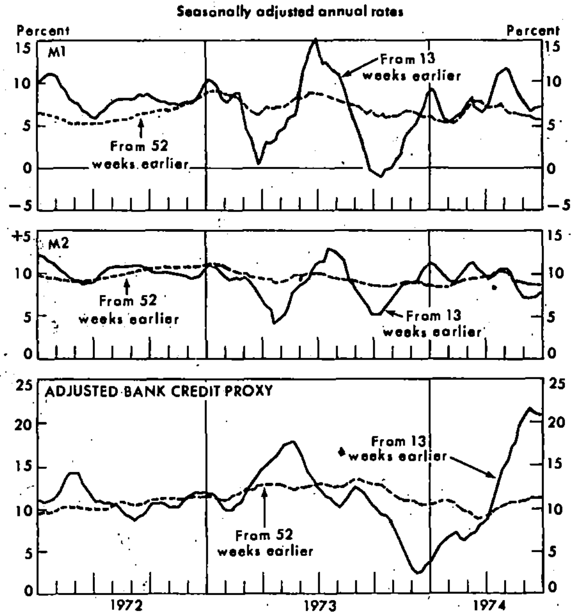
Maturity	Weekly auction dates—June 1974			
	June 3	June 10	June 17	June 24
Three-month	8.300	8.260	8.177	7.841
Six-month	8.426	8.324	8.175	8.003
	Monthly auction dates—May-June 1974			
	May 2	May 29	June 26	
Fifty-two weeks	8.421	8.248	8.256	

* 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.

Chart II

CHANGES IN MONETARY AND CREDIT AGGREGATES

Seasonally adjusted annual rates



Note: Growth rates are computed on the basis of four-week averages of daily figures for periods ended in the statement week plotted, 13 weeks earlier and 52 weeks earlier. The latest statement week plotted is June 26, 1974.

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.

THE OTHER SECURITIES MARKETS

Yields climbed sharply in the corporate and municipal bond markets during the month, with a record rate being set on one new issue, while other rates reached levels that had not prevailed since 1970. The persistence of rapid inflation and indications of heavy business demand for bank loans contributed to the general upward push in long-term rates. Faced with increased uncertainty with respect to future inflation, investors were reluctant to commit long-term funds at fixed rates. Consequently, a number of 25- to 35-year offerings attracted little investor interest, while shorter term issues generally sold well.

With both the current and future calendar of new issues expected to be heavy, underwriters were reluctant to build inventories and bid cautiously, setting large spreads between the net interest cost and the reoffering rates. On several occasions, terms were proposed that were deemed unacceptable by the borrowers, resulting in the cancellation or postponement of a number of issues.

To overcome the resistance to long-term commitments, a major bank holding company announced its plan to offer a fifteen-year note in July, with the interest rate subject to adjustment as the Treasury bill rate changes. Holders of the notes will have the opportunity, on thirty days' notice, to redeem the securities at 100 percent of their face value on any interest payment date.

When the month began, the market for corporate bonds was firm, amid predictions that credit demands would be easing and short-term interest rates would therefore turn down. Negotiated industrial and financial offerings sold well in the first week of June, and a five-year Aaa-rated utility bond was enthusiastically received when priced to yield 8.75 percent. In the following week, however, inflation and credit worries again increased and most short-term interest rates either held steady or began edging back up. Rates rose sharply on several long-term issues which were released from syndicate price restrictions—as much as 51 basis points in one case. Subsequently, the higher yields attracted some investor interest, but the latter was largely restricted to high-quality offerings with relatively short maturities.

Concern about the financial soundness of utility bonds, which had emerged when a major electric utility company reported financial difficulties, led to a preference for top-quality issues. Consequently there was a 165 basis point spread between two long-term utility bonds offered in the second week of June. A $90 million offering of Aaa-rated 34-year telephone debentures was priced to yield 8.75 percent. Two days later, an electric utility issued $50 million of 30-year mortgage bonds, which were rated A by Moody's and BBB by Standard and Poor's. The 10.40 percent yield was the highest available since late 1970 on a long-term issue with this rating. In the deteriorating market atmosphere, sales of both issues were slow. Yields climbed higher in subsequent trading. At the end of the month, the telephone issue was trading at a price to yield 9.52 percent while the electric utility bonds were quoted at 11.48 percent.

In the final week, another Bell Telephone subsidiary, rated Aaa by Moody's but AA by Standard and Poor's, marketed $250 million of 37-year debentures. The issue offered a 9½ percent return, the highest ever on a Bell Telephone unit debt offering, topping the previous 9.35 percent rate set in June 1970. This issue sold well but was trading at a small discount from the original price by the month end.

Investor preference for intermediate-term offerings led to quick sales of three eight-year bond issues marketed in the third and fourth weeks of the month. The first, with a solid A rating, was priced to yield 10.10 percent, and the second, which carries a rating of Aa from Moody's and an A rating from Standard and Poor's, was priced to yield 10 percent. A 10 percent yield was also available on the final issue, sold June 27 with a straight Aa rating.

The tax-exempt sector also suffered from a heavy calendar and generally slack demand. Early in the period, several issues met with good receptions. For instance, the state of Ohio easily sold $50 million of Aaa-rated bonds June 4, with yields ranging from 5.20 percent in 1974 to 5.60 percent in 1990. As the month progressed, demand diminished despite generally higher yields. In the final week, a portion of an Aaa-rated offering by a number of local housing authorities had to be canceled because of the 6 percent legal ceiling on these obligations. However, the portion that was sold attracted good retail demand when priced to yield from 5.25 percent in 1975 to 6 percent in 2004-15. The Bond Buyer index rose 25 basis points to 6.33 percent between May 30 and June 27. Dealers met with limited success in reducing inventories in anticipation of further new issues. The Blue List of dealers' advertised inventories fell $37 million to $580 million.