The Money and Bond Markets in February

Interest rate movements in February were mixed, as short-term rates tended to move up while longer term yields were either little changed or edged lower. This flattening of the yield curve came in response to the economic indicators published during the month, showing additional signs of strengthening in economic activity combined with moderating rates of inflation. Short-term rates are fairly sensitive to changes in economic activity, money growth rates, and the Federal funds rate. Expectations of further declines in the Federal funds rate gradually were dissipated during the period. Indeed, by the month end, many market participants were expecting the funds rate to rise.

The improvements in the longer term area were most evident in the corporate sector. Yields on corporate issues declined over most of February, as participants were particularly encouraged by the latest readings on inflation. Late in the period, however, the calendar of new issues increased substantially in response to the reduced borrowing costs, and yields backed up, retracing part of the earlier declines. In the Treasury coupon sector, continued concern over the financing of the Treasury's deficit offset the effects of the favorable price news and yields fluctuated narrowly over the month.

Preliminary estimates indicate that growth in the money stock measures accelerated sharply in February. The narrowly defined money stock (M_1) increased at a rather brisk pace, following a decline in December and only limited growth in January. Growth in the more broadly defined money stock (M_2) also picked up, surpassing even its strong performance in the previous month. The bank credit proxy remained depressed in February, as the volume of large negotiable certificates of deposit (CDs) continued to decline.

THE MONEY MARKET AND THE MONETARY AGGREGATES

The Federal funds rate fluctuated narrowly in February, while other short-term interest rates rose on balance (see Chart I). Over the month as a whole, the effective rate on Federal funds averaged 4.77 percent, little changed from the rate that prevailed over most of January. Most rates had moved down in January in response to the early reduction in the Federal funds rate and anticipations that it would fall farther. When no further declines emerged and there was evidence of strengthening economic activity, interest rates backed up. Rates on 90- to 119-day dealer-placed commercial paper closed the period at 5⅛ percent, up 13 basis points from the end of January, while rates on 90-day bankers' acceptances rose 23 basis points to 5.15 percent. At the month end, CDs maturing in 90 days were trading in the secondary market at 5.13 percent, an increase of 11 basis points over the period.

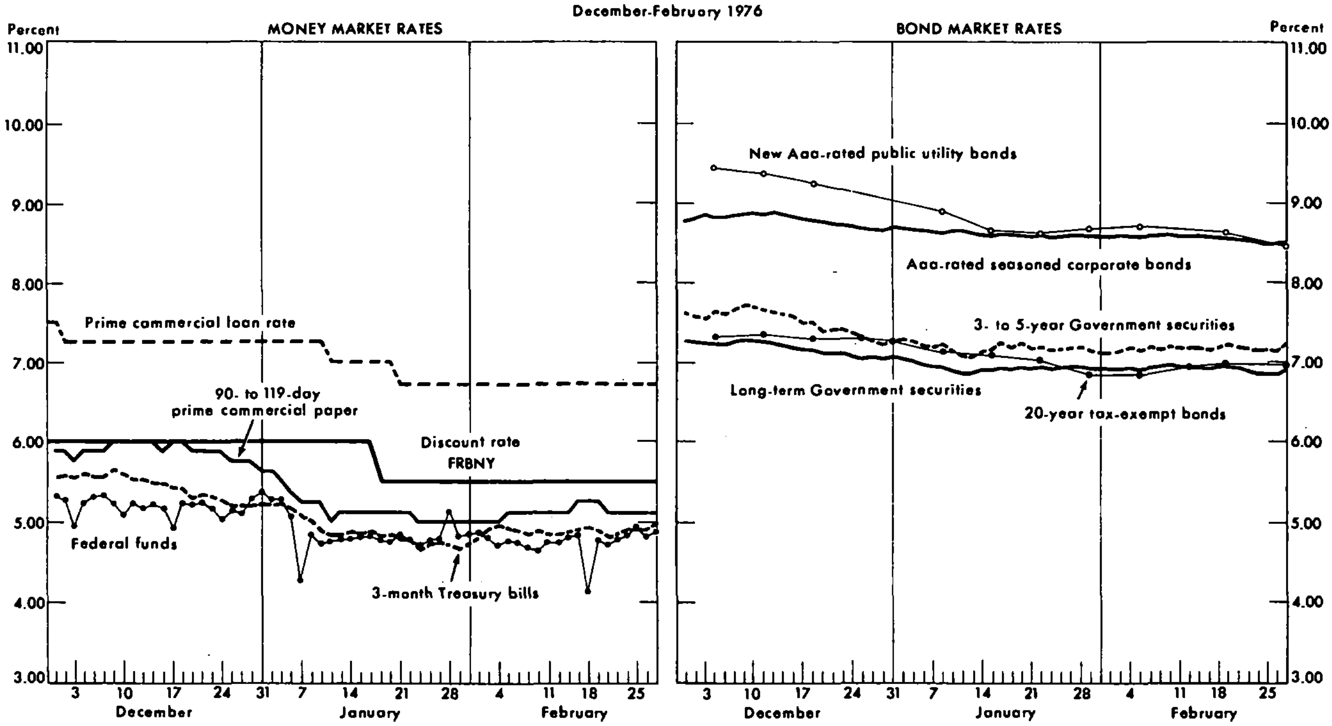
Weakness was still quite evident in business demand for short-term credit in February. Over the four statement weeks ended February 25, commercial and industrial loans at large commercial banks fell $769 million. Part of this decline was accounted for by a $165 million drop in bank holdings of bankers' acceptances. Loans less acceptances declined by $604 million, compared with an average decrease of $155 million over similar periods in the previous two years. The prevailing prime rate was unchanged during February at 6¾ percent, although one major bank lowered its rate by ¼ percentage point to 6½ percent early in the month and then returned it to 6¾ percent at the month end. Borrowing from the Federal Reserve Bank discount window remained minimal until the final week, when settlement-day pressures in the Federal funds market emerged (see Table I).

According to preliminary data, M_1—private demand deposits adjusted plus currency outside commercial banks—showed renewed vigor in February. Over the four weeks ended February 25, seasonally adjusted M_1 averaged 7.5 percent on an annual basis above its level over the previous four weeks. From a longer term perspective, M_1 has been unusually weak, advancing by only 2.5 percent in the most recent 26-week period and 1.8 percent in the latest statistical quarter (see Chart II). In contrast, M_2—M_1 plus time and savings deposits other than large CDs—has grown rapidly in recent months, as relatively low money market interest rates have stimulated demand for

Chart I

SELECTED INTEREST RATES

December-February 1976



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.

small- to medium-size time and savings deposits. Over the four-week period ended February 25, M_2 growth accelerated to 15.6 percent from its average level over the previous four weeks, bringing the gain for the latest statistical quarter to 9.3 percent. The bank credit proxy—total member bank deposits subject to reserve requirements plus certain nondeposit sources of funds—continued to advance at a sluggish pace in February largely as a result of a sharp decline in CDs.

THE GOVERNMENT SECURITIES MARKET

Treasury bill rates rose moderately in early February and then stabilized at new higher levels until advancing further at the close. This upward adjustment partly reflected a reversal of larger than sustainable declines registered in the previous month. Though financing costs were fairly steady in February, prospects for price gains on bills were reduced as expectations of further declines in the funds rate faded. At the same time, substantial supplies continued to flow into the market through the regular weekly bill auctions. In this atmosphere, bill rates for all maturities moved higher. Three- and six-month bills were sold at average yields of 4.87 percent and 5.20 percent, respectively, at the final regular auction of the month (see Table II), up 11 and 15 basis points from average yields at the last auction in January. The auction of fifty-two week bills occurred early in February, and the average issuing rate was almost unchanged from the previous month. Rates on most issues ended the month 25 to 55 basis points above the levels at the end of January.

Prices of coupon issues fluctuated narrowly in February, as underlying market considerations about offset each other. A key issue was the inflation outlook, and announcements during the month of January's consumer and wholesale price indexes indicated an improvement in that area. Partly offsetting this effect, however, was the sharp decline in the unemployment rate in January, which some investors interpreted as implying that the economy was recovering faster than expected. In addition, the prospect of further heavy sales of Treasury obligations continued to weigh on market sentiment. Over the month as a whole, the index of intermediate-term Government securities rose by 8 basis points to 7.22 percent while the index of long-term Government bonds fell by 1 basis point to 6.91 percent.

The Treasury raised $10.2 billion of new cash in February. At the beginning of the month, $5.1 billion of that amount was obtained in the refunding operation, as the Treasury sold $3 billion of three-year notes at 7.05 percent and $400 million of 29-year three-month bonds at 8.09 percent and accepted subscriptions for $6 billion of seven-year 8 percent notes. The seven-year notes were heavily oversubscribed and immediately traded at a premium in the secondary market.* On February 20, $2.5 billion of new cash was raised through the auction of 21-month notes at an average yield of 6.62 percent. An additional $2.6 billion of new cash was obtained in the regular weekly and monthly Treasury bill auctions, although this quantity was low relative to previous months.

Yields on Federal Government agency issues fluctuated over a narrow range in February, paralleling movements in the Treasury coupon market. Early in the month, the Federal Home Loan Banks offered $500 million of five-year 7.60 percent bonds and the Federal Home Loan Mortgage Corporation offered $200 million of 8.55 percent thirty-year guaranteed mortgage certificates. Both issues immediately traded at discounts but edged back toward par during the month. Later in February, the Farm Credit Banks raised $93.5 million of new cash by offering $421.1 million of 5.45 percent six-month Banks for Cooperatives bonds and $1,037.5 million of 5.80 percent nine-month Federal Intermediate Credit

* For more details on the Treasury's refunding operations in early February, see this *Review* (February 1976), pages 48-49.

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, FEBRUARY 1976

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

Factors	Changes in daily averages— week ended				Net changes
	Feb. 4	Feb. 11	Feb. 18	Feb. 25	
"Market" factors					
Member bank required reserves	+ 244	+ 939	— 315	+ 264	+1,132
Operating transactions (subtotal)	—1,610	+2,762	—1,750	—2,885	—3,483
Federal Reserve float	— 191	+ 170	— 194	+ 746	+ 531
Treasury operations*	—1,413	+2,842	— 437	—3,417	—2,425
Gold and foreign account	— 38	+ 21	— 32	+ 1	— 48
Currency outside banks	— 56	— 587	— 917	— 70	—1,630
Other Federal Reserve liabilities and capital	+ 88	+ 316	— 172	— 145	+ 87
Total "market" factors	—1,366	+3,701	—2,065	—2,621	—2,351
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	+1,605	—4,050	+2,655	+2,429	+2,639
Outright holdings:					
Treasury securities	+ 448	— 100	+ 891	+ 855	+2,094
Bankers' acceptances	— 7	— 9	— 23	— 18	— 57
Federal agency obligations	—	— 1	—	—	— 1
Repurchase agreements:					
Treasury securities	+ 941	—3,288	+1,595	+1,320	+ 568
Bankers' acceptances	+ 182	— 398	+ 109	+ 233	+ 126
Federal agency obligations	+ 41	— 254	+ 83	+ 39	— 91
Member bank borrowings	— 3	— 4	+ 5	+ 92	+ 90
Seasonal borrowings†	+ 3	—	— 1	—	+ 2
Other Federal Reserve assets‡	+ 49	+ 12	— 148	— 576	— 663
Total	+1,650	—4,042	+2,512	+1,945	+2,065
Excess reserves‡§	+ 284	— 341	+ 447	— 676	— 286
	Daily average levels				Monthly averages‖
Member bank:					
Total reserves, including vault cash‡§	35,115	33,842	34,604	33,664	34,306
Required reserves	34,658	33,719	34,034	33,770	34,045
Excess reserves§	457	123	570	— 106	261
Total borrowings	55	51	56	148	78
Seasonal borrowings†	11	11	10	10	11
Nonborrowed reserves	35,060	33,791	34,548	33,516	34,229
Net carry-over, excess or deficit (—)¶	58	198	56	233	136

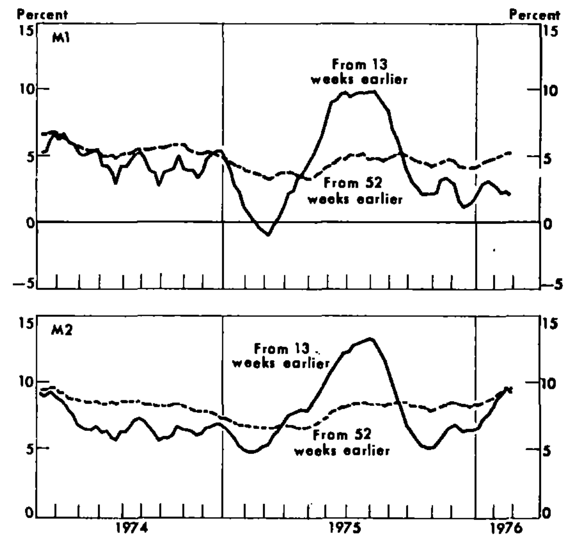
Note: Because of rounding, figures do not necessarily add to totals.
* Includes changes in Treasury currency and cash.
† Included in total member bank borrowings.
‡ Includes assets denominated in foreign currencies.
§ Adjusted to include waivers of penalties for reserve deficiencies in accordance with the Regulation D change effective November 19, 1975.
‖ Average for four weeks ended February 25, 1976.
¶ Not reflected in data above.

Bank bonds. Both issues were well received. On February 19, the Government National Mortgage Association successfully marketed $295 million of new modified pass-through bonds. This issue included $204 million of securities with 7½ percent coupons priced to yield 8.32 percent in thirty years and $91 million with 7¼ percent coupons returning 8.28 percent in thirty years. Since these securities pay interest monthly rather than semiannually as do most bonds, the effective yields were actually boosted to 8.47 percent and 8.42 percent, respectively.

Chart II

GROWTH OF SELECTED MONEY STOCK MEASURES

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 February 25, 1976.

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.

Source: Board of Governors of the Federal Reserve System.

OTHER SECURITIES MARKETS

Yields on corporate bonds declined during most of February and ended the month lower on balance, although part of the decline was reversed at the month end. Market sentiment benefited from the improved inflation outlook and by the unusually large net repayments to holders of maturing Government agency issues. A sizable volume of new issues was sold at lower interest rates in February, while yields in the secondary market including those on lower rated issues also declined. At the end of the period, however, reduced borrowing costs prompted a number of corporations to announce plans for new offerings, and the calendar increased substantially. In this atmosphere, prices began to retreat slightly, leaving some very aggressively priced new issues in syndicate hands at yields considerably below those available in the market.

Until the final days in February, new corporate issues generally met good receptions at rates substantially lower than those obtained a month earlier. Four electric utilities placed thirty-year A-rated bonds at yields ranging from 9 to 9⅛ percent, about ⅝ to 1 percentage point below issuing yields on similar bonds sold in January. Two Aa-rated 25-year industrial debentures were accorded good receptions at yields of 8.40 percent and 8.45 percent, compared with an 8.80 percent return provided in January on a similarly rated offering. At the end of the month, market sentiment shifted and two aggressively priced issues were poorly received. An Aaa-rated telephone issue was won in close competitive bidding and was reoffered at an 8.34 percent return, and an Aaa-rated industrial issue was priced to yield 8.30 percent in a negotiated underwriting. These yields were 26 and 50 basis points below comparably rated issues offered in January. Both issues were subsequently released from syndicate and traded at prices below those originally quoted.

A condition of oversupply continued to exist in the tax-exempt market in February, and this was reflected

Table II

AVERAGE ISSUING RATES AT REGULAR TREASURY BILL AUCTIONS*

In percent

Maturity	Weekly auction dates—February 1976			
	Feb. 2	Feb. 9	Feb. 13	Feb. 23
Three-month	4.811	4.872	4.854	4.870
Six-month	5.066	5.133	5.171	5.204

Maturity	Monthly auction dates—December 1975-February 1976		
	Dec. 10	Jan. 7	Feb. 4
Fifty-two weeks	6.439	5.578	5.572

*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.

in the pricing of several large new issues at yields above those on comparable securities in January. Early in the month, \$150 million of State of Illinois bonds rated Aaa by Moody's and Aa by Standard & Poor's was well received at yields ranging from 3.75 percent in 1979 to 6.20 percent in 2001. Later in the month, a Maryland offering of \$150 million of Aaa-rated serial bonds was priced to yield from 4.2 percent in 1979 to 5.9 percent in 1991. Yields on both of these issues were higher than those obtained on a similarly rated state offering the month before, which had provided returns from 3.10 percent in 1977 to 5.70 percent in 1996. The attractive pricing of the Maryland bonds, however, was partly attributed to the state's frequent trips to the market in recent years. Over the month as a whole, The Bond Buyer index of twenty bond yields on twenty-year tax-exempt bonds rose 13 basis points to 6.98 percent. The Blue List of dealers' advertised inventories fell by \$25 million and closed the month at \$702 million.