The Money and Bond Markets in May

Interest rates in the money and bond markets rose further in May. The increases in rates on short-term money market instruments reflected firmer conditions in the market for Federal funds, as the Federal Reserve became somewhat less accommodative in its approach to supplying reserves. The Federal funds rate averaged 5.29 percent in May, up about ½ percentage point from April's average, and other short-term interest rates rose by similar amounts. In the bond market, yields also adjusted upward, bringing long-term rates to the highest levels this year.

The Treasury completed its quarterly refunding operation early in May and borrowed an additional $750 million in a note sale later in the month. In the corporate and municipal bond markets, new issue activity was heavy but some planned financings were postponed as borrowing costs rose sharply.

Preliminary data indicate that the money stock expanded more moderately in May than in April, although the pace was still substantial. Business loan demand remained weak through the statement week ended May 26, however, and banks continued to allow the volume of outstanding negotiable certificates of deposit (CDs) to decrease over the month. As a result, the bank credit proxy—total member bank deposits subject to reserve requirements plus certain nondeposit sources of funds—declined over the month despite the strength of deposit growth.

THE MONEY MARKET AND THE MONETARY AGGREGATES

Interest rates on money market instruments rose substantially in May, reflecting firmer conditions in the Federal funds market. The effective rate on Federal funds averaged 5.50 percent in the statement week ended May 26 (see Chart I), compared with a 4.93 percent average in the last week of April. By the end of May, yields on 90- to 119-day commercial paper were up 63 basis points to 5.75 percent, while rates on 90-day bankers' acceptances rose by 82 basis points over the month to close at 5.90 percent. The average yield on 90-day CDs in the secondary market ended the month at 5.88 percent, up 75 basis points from the average rate at the end of April. These interest rate increases placed some pressure on banks to raise their lending rates to prime customers, and at the end of the month most large banks raised their rates to 7 percent despite the continued weakness in business loan demand. With Federal funds trading near the discount rate, member banks increased their average borrowings at Federal Reserve Banks to $86 million (see Table I).

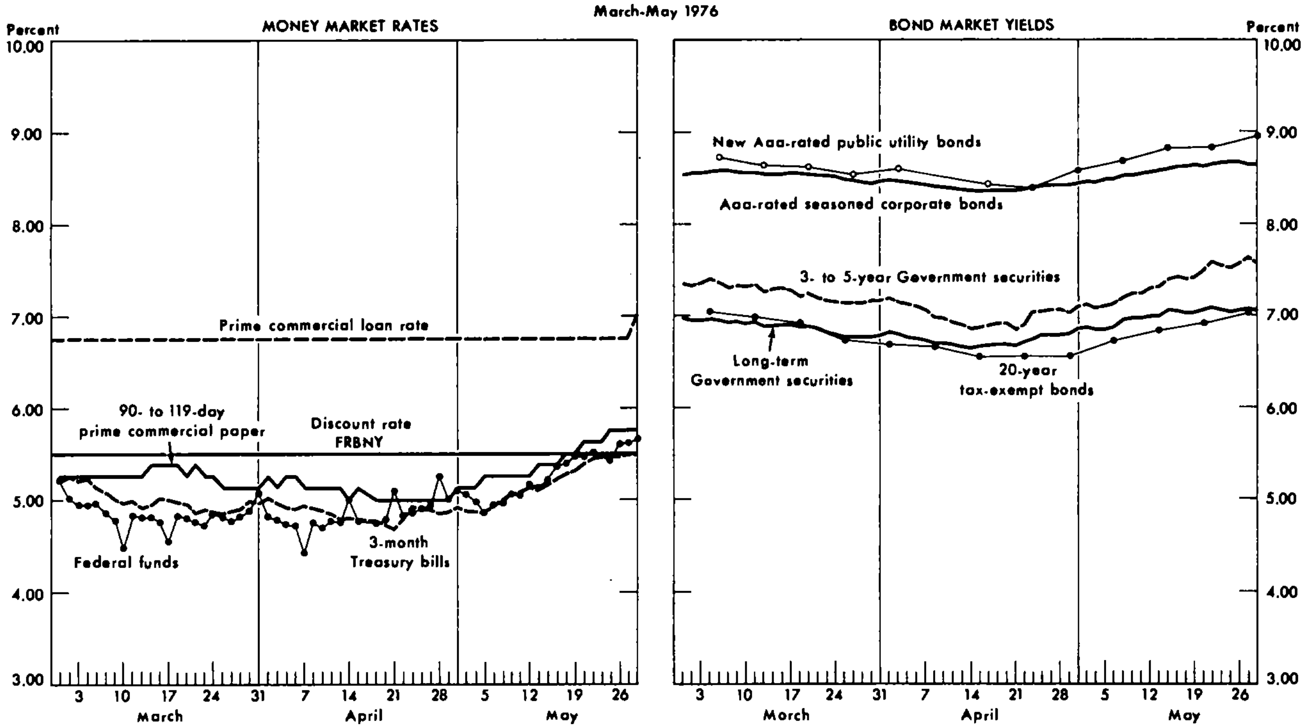
In line with the pattern observed throughout the current recovery period, the demand for business loans was again weak in May. Commercial and industrial loans at all weekly reporting banks, including loans sold to affiliates, fell by $1 billion over the four statement weeks ended May 26. These declines totaled $10.6 billion over the 52-week period ended then, despite the gradual increase in business inventories which are typically financed by bank loans. The declines in loans have not been offset by increases in the amount of commercial paper outstanding, which suggests that inventory accumulation has been financed largely by internal corporate funds.

Estimates of the monetary aggregates (which reflect the recent quarterly revisions) indicate that they grew fairly rapidly in May although considerably slower than they did in April. During the four-week period ended May 26, seasonally adjusted M_1—private demand deposits adjusted plus currency outside commercial banks —increased at an annual rate of 9.2 percent over its four-week average in the period ended thirteen weeks earlier (see Chart II). This increase brought the four-week average level of M_1 to 5.5 percent over its four-week average level in the period ended 52-weeks earlier. M_2—M_1 plus commercial bank time and savings deposits other than large negotiable CDs—grew at an annual rate of 11.2 percent over its four-week average ended thirteen weeks earlier and at 10.0 percent over its four-week average ended 52-weeks earlier. Long-run target ranges specified at the April 20 meeting of the FOMC called for growth in M_1 between 4½ and 7 percent and growth in M_2 between 7½ and 10 percent at an annual rate. The decline in

Chart I

SELECTED INTEREST RATES

March-May 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.

CDs of $3.3 billion over the month held the rate of growth in the bank credit proxy to only 3.0 percent over its average level of a year ago.

THE GOVERNMENT SECURITIES MARKET

Yields on United States Treasury securities increased in May, reflecting the firmer money market conditions and competition from a substantial volume of new corporate and municipal issues. After modest declines early in May, just prior to the Treasury's refunding operation, yields quickly advanced to new highs for the year.

The Treasury financing in early May, consisting of new two- and ten-year notes and 23¾-year bonds, was well received by investors. In response, the Treasury issued $1.2 billion more than the initially scheduled $3.5 billion of the 7⅞ percent ten-year notes. The yield to maturity on the $750 million bond issue averaged 8.19 percent, while $2.0 billion of two-year notes yielded 6.61 percent. The extent of general yield increases over the course of the month can be seen by comparing the yield on the two-year note issued on May 19 with the two-year note issue described above. The $2.25 billion issue of two-year notes on May 19, which included $750 million of new cash borrowing, was placed at an average interest cost of 7.16 percent, 55 basis points above the earlier issue.

Treasury bill rates reflected the considerable firming in the money markets. In the last May auction (advanced to May 28 because of the Memorial Day holiday), average issuing rates on three- and six-month bills, respectively, were 67 and 72 basis points higher than at the last auction in April. The auction of 52-week bills on May 26 resulted in an average issuing yield of over ⅝ percentage point higher than in the April auction (see Table II). Rates on most bill issues ended May about 30 to 80 basis points above levels at the end of the previous month.

New Federally sponsored agency issues were well received during the month. On May 5 the Federal Home Loan Banks offered only $300 million of 7¾ percent consolidated eight-year bonds, although $900 million of securities was maturing. This was a continuation of the tendency toward debt retirement by housing agencies, reflecting the highly liquid positions of thrift institutions in recent months. As a result of the reduced supply of agency issues, spreads between agency and Government securities yields remained narrow by historical standards. On May 13, the Federal Intermediate Credit Banks (FICB) and the Banks for Cooperatives (BC) placed nearly $1.4 billion of short-term bonds but raised only $88 million in new cash. The $946 million nine-month FICB offering was priced at par to yield 6¼ percent, and the six-month BC issue returned 5.80 percent on nearly $411 million. The 7¼ percent and 7½ percent mortgage-backed securities of the Government National Mortgage Association continued to be popular with investors, and a substantial quantity of thirty-year modified pass-through securities was placed quickly on May 13. In this offering, $147.8 million of the 7¼ percent bonds and $195.5 million of the 7½ percent securities were priced to yield an 8.46 percent annual return, paid monthly; the equivalent corporate bond yield would be 8.61 percent.

OTHER SECURITIES MARKETS

Yields moved sharply higher in the corporate and municipal bond markets, as large supplies of new issues came to market and participants apparently revised their expectations substantially. Accordingly, considerably higher yields became available on seasoned issues. As the yields required for successful distribution of new issues rose, some borrowers postponed planned financings. Nevertheless, underwriting syndicates placed a sizable volume of medium-quality fixed-income obligations, indicating further relaxation of previous insistence by investors on prime-quality debt.

The increase in bond yields was exemplified by three new Aa-rated electric utility issues with thirty-year maturities. A $45 million offering was distributed at the end of April with a yield of 8.70 percent. Early in May,

Table I

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

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

Factors	Changes in daily averages— week ended				Net changes
	May 5	May 12	May 19	May 26	
"Market" factors					
Member bank required reserves	— 563	+1,063	— 141	+ 381	+ 740
Operating transactions (subtotal)	—1.768	+2,517	— 791	—2,204	—2.246
Federal Reserve float	+ 205	— 78	— 15	— 495	— 383
Treasury operations*	—2.043	+2.490	— 40	—1,542	—1,135
Gold and foreign account	— 46	— 43	+ 27	+ 68	+ 6
Currency outside banks	+ 169	— 287	— 730	— 4	— 852
Other Federal Reserve liabilities and capital	— 53	+ 436	— 34	— 231	+ 118
Total "market" factors	—2.331	+3,580	— 932	—1.823	—1.506
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	+2,600	—4.089	+1,490	+2.012	+2,013
Outright holdings:					
Treasury securities	+ 322	—1.190	+ 678	+ 787	+ 597
Bankers' acceptances	— 8	+ 3	— 18	— 27	— 50
Federal agency obligations	—	—	—	+ 234	+ 234
Repurchase agreements:					
Treasury securities	+1.972	—2.491	+ 663	+ 801	+ 945
Bankers' acceptances	+ 273	— 320	+ 107	+ 174	+ 234
Federal agency obligations	+ 41	— 91	+ 60	+ 43	+ 53
Member bank borrowings	— 23	+ 26	+ 65	+ 14	+ 82
Seasonal borrowings†	—	— 2	+ 1	+ 1	—
Other Federal Reserve assets‡	+ 101	— 41	— 346	— 278	— 564
Total	+2.679	—4,104	+1.209	+1.748	+1,532
Excess reserves‡§	+ 348	— 524	+ 277	— 75	+ 26
	Daily average levels				**Monthly averages‖**
Member bank:					
Total reserves, including vault cash‡§	35.314	33.727	34.145	33.689	34,219
Required reserves	34,817	33.754	33.895	33,514	33,995
Excess reserves§	497	— 27	250	175	224
Total borrowings	30	56	121	135	86
Seasonal borrowings†	11	9	10	11	10
Nonborrowed reserves	35.284	33,671	34.024	33.554	34,133
Net carry-over, excess or deficit (—)¶	— 77	212	10	72	54

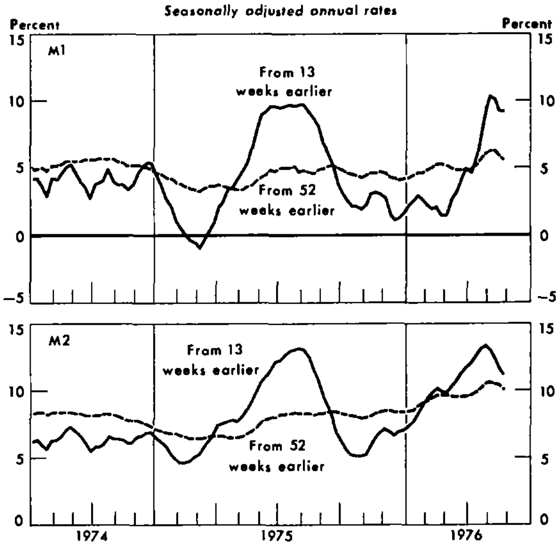
Note: Because of rounding, figures do not necessarily add to totals.
* Includes changes in Treasury currency and cash.
† Included in total member bank borrowings.
‡ Includes assets denominated in foreign currencies.
§ Adjusted to include waivers of penalties for reserve deficiencies in accordance with the Regulation D change effective November 19, 1975.
‖ Average for four weeks ended May 26, 1976.
¶ Not reflected in data above.

$40 million of new bonds provided an 8.88 percent return, while $25 million of bonds was sold at 9.30 percent at the end of the month. The large premium that investors still will pay for high-quality debt was indicated in the following two industrial underwritings. A yield of 8.50 percent was sufficient for successful sale of $300 million of Aaa-rated thirty-year debentures, but $200 million of Aa-rated 25-year debentures was priced to provide an 8.90 percent return.

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 May 26, 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.

Table II

AVERAGE ISSUING RATES AT REGULAR TREASURY BILL AUCTIONS*

In percent

Maturity	Weekly auction dates—May 1976				
	May 3	May 10	May 17	May 24	May 28
Three-month	4.921	5.072	5.250	5.495	5.578
Six-month	5.339	5.426	5.726	5.908	5.952
	Monthly auction dates—March-May 1976				
	March 3	March 31	April 29	May 26	
Fifty-two weeks	6.010	5.781	5.645	6.309	

* 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.

Investors were offered a variety of state obligations during the month. In Aaa-rated issues, yields from 3.5 percent in 1977 to 6.3 percent in 1998 were provided by North Carolina bonds late in the month, compared with 3.3 percent in 1977 and 6.45 percent in 2001 on Illinois bonds at midmonth and 3.2 percent in 1977 to 5.85 percent in 1996 on Tennessee bonds (rated AA by Standard & Poor's) in late April. A $59 million New York State issue, rated A/AA (Moody's/Standard & Poor's), was well received when offered at yields of 4.75 percent in 1977 to 7.60 percent in 2001. This marked the first public placement of New York State bonds in more than a year and a half. The Bond Buyer index of twenty bond yields on twenty-year tax-exempt bonds rose 48 basis points over the month to 7.03 percent, reflecting the extent of interest rate increases in May. The Blue List of dealers' advertised inventories rose by $28 million to close the month at $825 million.