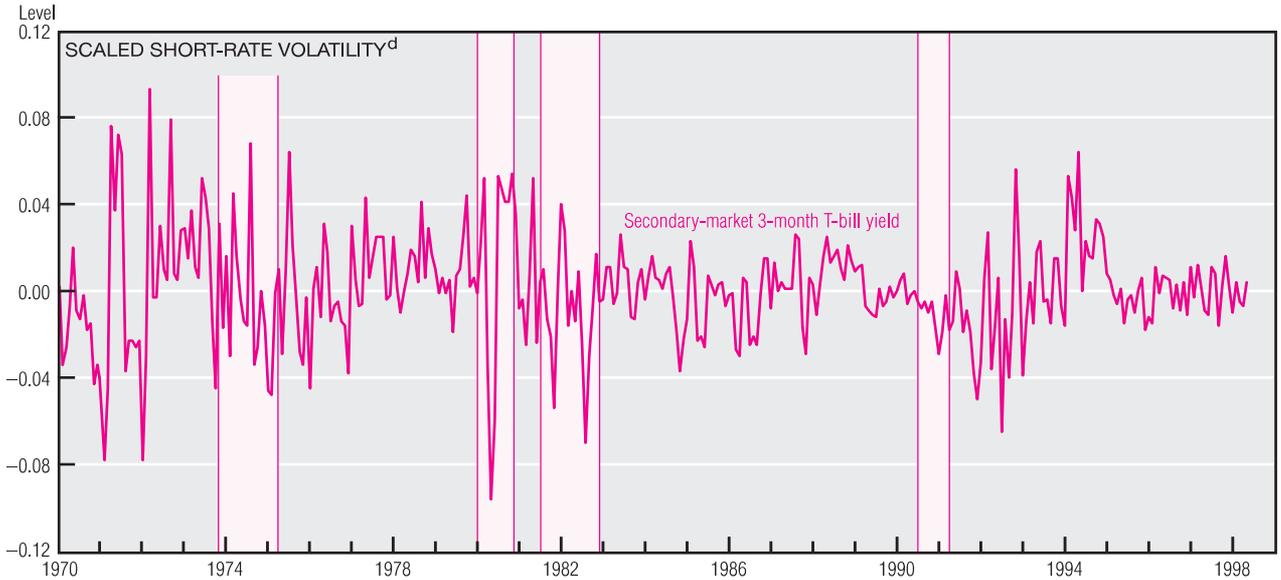
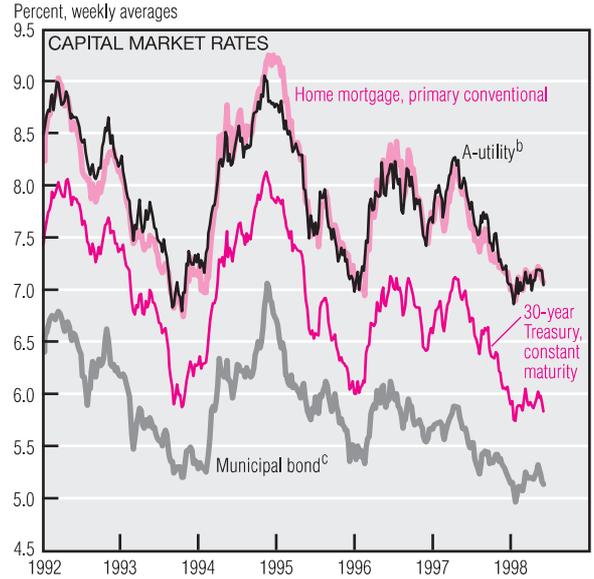
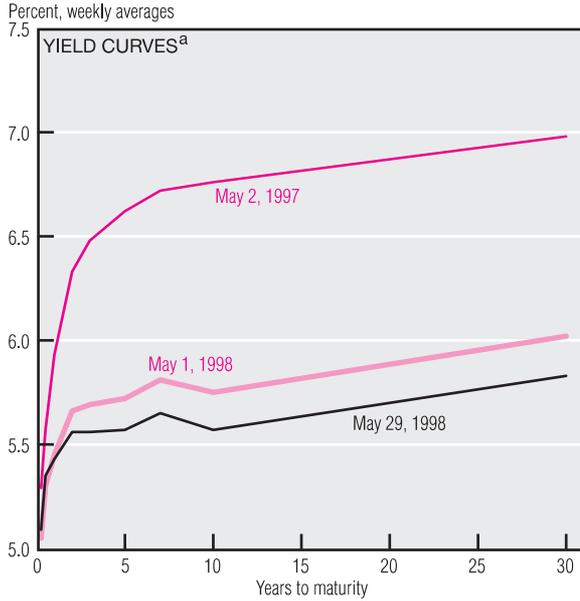


Interest Rates



a. All instruments are constant-maturity series.

b. Estimate of the yield on a recently offered, A-rated utility bond with a maturity of 30 years and call protection of five years.

c. Bond Buyer Index, general obligation, 20 years to maturity, mixed quality.

d. Volatility measures the day-to-day change in the Treasury rate. Scaling compensates for the propensity of volatility to increase and decrease as rates rise and fall, and for the tendency of this relationship to be nonlinear.

NOTE: Shaded areas indicate recessions.

SOURCE: Board of Governors of the Federal Reserve System.

The yield curve remains relatively flat; short rates have moved up and long rates have moved down since last month. The often-watched 3-year, 3-month spread has narrowed from 64 basis points to 47, and the popular 10-year, 3-month spread has moved from 70 basis points to 48. Both remain well below their historical averages of 80 and 120 basis points, respectively. The middle range continues to show an inversion, with 7-year rates 8 basis points above 10-year rates.

Such a flat curve generally indicates slower economic growth, but the yield curve has been underpredicting GDP growth for about a year now. Previous episodes of flattening were driven by an increase in short rates; this time, however, the yield curve has flattened primarily because long rates have fallen. This trend is apparent in mortgages, municipal bonds, and utility rates, as well as in 30-year Treasury bonds.

Short rates appear rather quiet by other measures as well. The monthly

variance of the 3-month T-bill yield (scaled to account for the fact that bigger changes occur more often at higher interest rates) has been remarkably stable since the spring of 1995. Some of this stability probably reflects monetary policy and the absence of recessions, as a glance at the turbulent years of 1979–82 will confirm. The most recent period indicates that rapid economic growth and wide swings in interest rates need not produce turmoil in the bond markets.