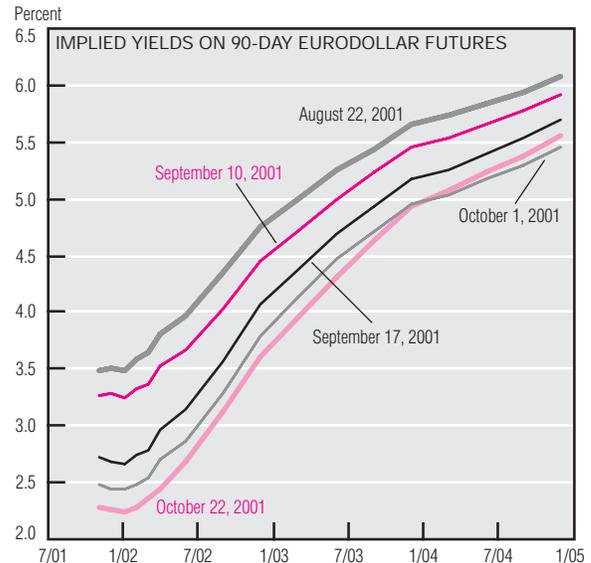
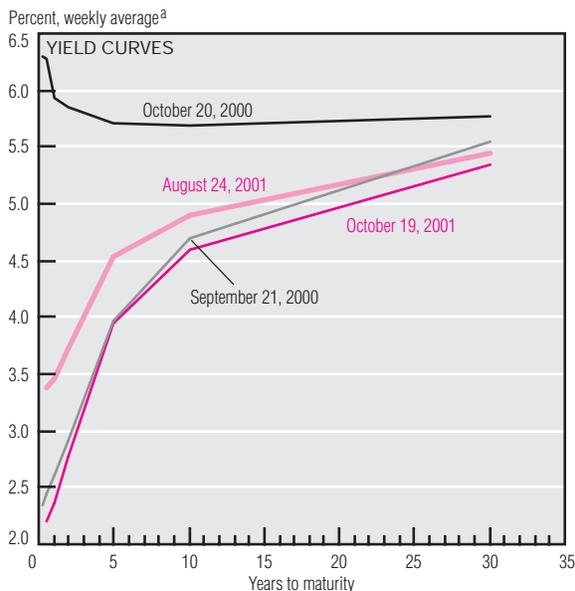
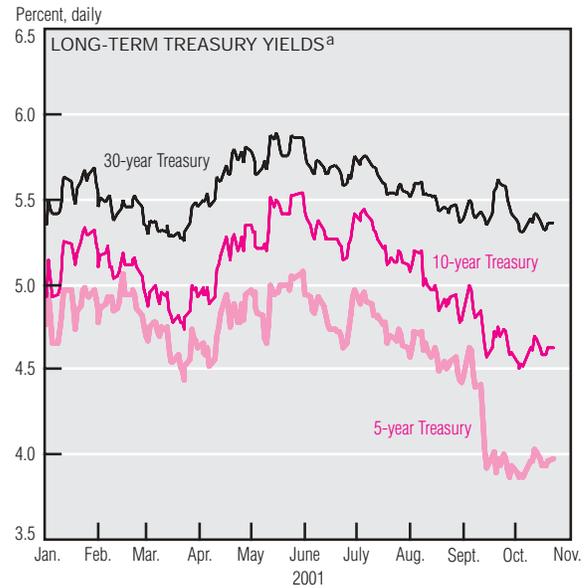


Money and Financial Markets



a. Constant maturity.
 SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; and Bloomberg Financial Information Services.

Short-term Treasury yields plummeted immediately after the September 11 terrorist attacks and have declined further since then, at least for maturities longer than three months. Much of the initial decrease showed that actual and anticipated cuts in the target federal funds rate had already been priced in. Stock indexes also performed fairly well after dropping steeply the first week after the New York Stock Exchange reopened.

Yields on longer-term Treasuries fell less precipitously than short-term

rates during the week after the attacks. In fact, the 30-year Treasury yield is now about the same as it was before September 11. Longer-term Treasury yields recently bounced up after the Treasury sold \$6 billion in 10-year notes in an unscheduled auction on October 5. This apparently relieved a supply scarcity that was leading to an inordinate number of failed trades in the repo market.

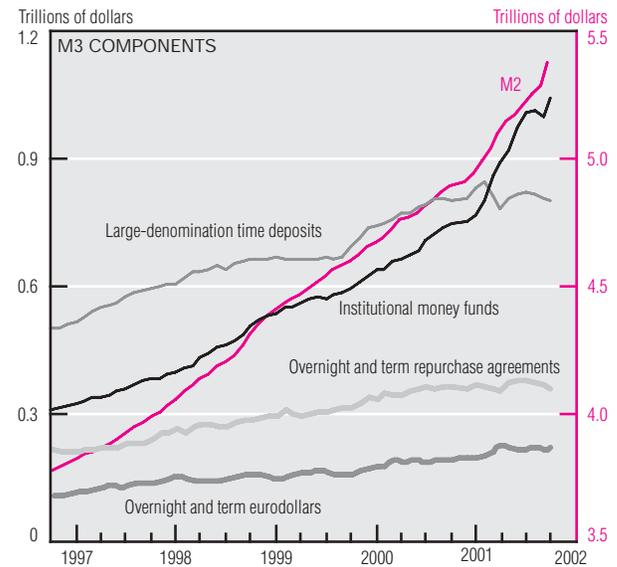
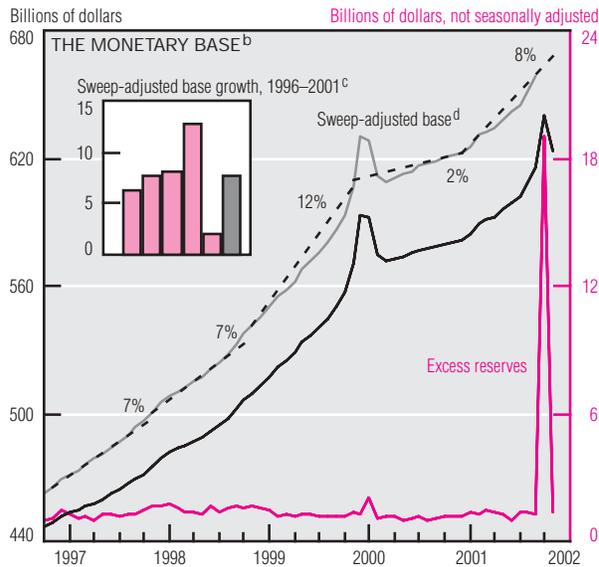
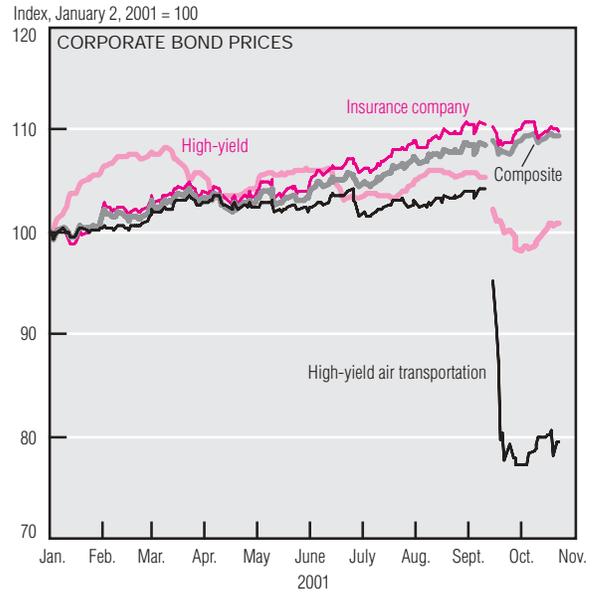
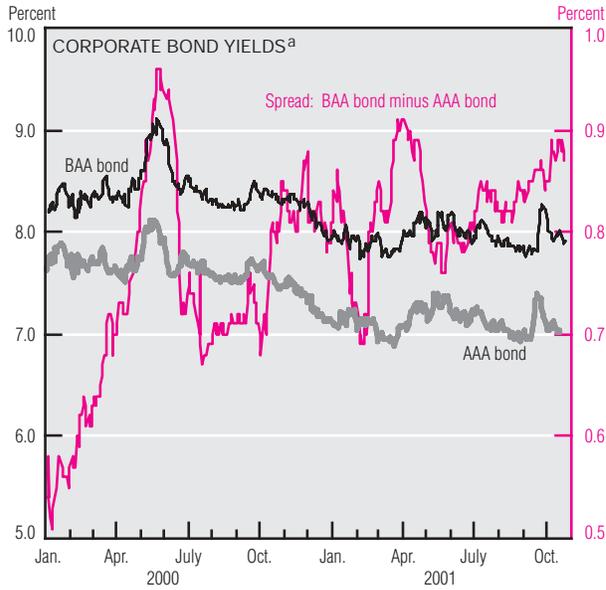
The yield curve, which assumed its conventional upward slope almost a year ago, has been steepening over the past several months.

A steepening yield curve often is viewed as a prelude to economic recovery, but it is unclear whether this scenario will play out. With inflation pressures apparently under control, speculation about renewed government debt financing may be buoying long-term yields.

Euro futures are used to hedge against funds rate movements, especially at longer maturities where they are more heavily traded than federal funds futures. Year-end forecasts of the funds rate implied by euro futures

(continued on next page)

Money and Financial Markets (cont.)



a. Daily average of seasoned bonds with remaining maturities of at least 20 years.

b. Last plots for the monetary base and excess reserves are estimated for October 2001. Last plot for the sweep-adjusted base is August 2001.

c. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. The 2001 growth rate for the sweep-adjusted base is calculated on an August over 2000:IVQ basis.

d. The sweep-adjusted base contains an estimate of required reserves saved when balances are shifted from reservable to nonreservable accounts. Dashed lines represent growth rates and are for reference only.

SOURCES: Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Releases*, "Aggregate Reserves of Depository Institutions and the Monetary Base," H.3; "Money Stock and Debt Measures," H.6, and "Selected Interest Rates," H.15; Bloomberg Financial Information Services; and Merrill Lynch and Co., Inc.

declined both before and after September 11. Throughout the past two months, however, market participants have continued to expect that rates would begin rising sometime early next year.

Corporate bond yields spiked for several weeks after the attacks but have since moved down, approaching their pre-September 11 levels. Companies reportedly found it unusually difficult to raise financing in the debt markets without offering premium interest rates. This was how

Ford Motor Co. was able to issue \$9.4 billion in debt on October 22, the largest corporate debt issuance to date.

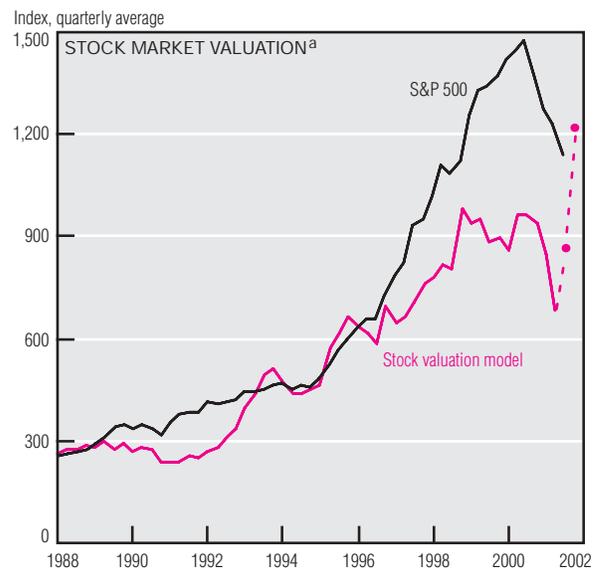
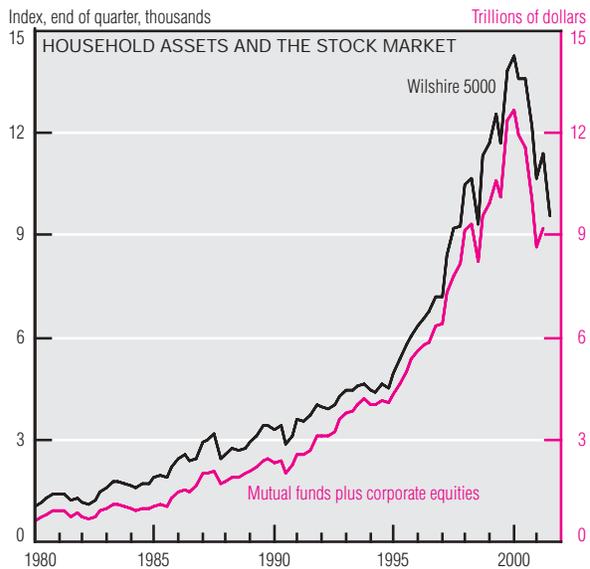
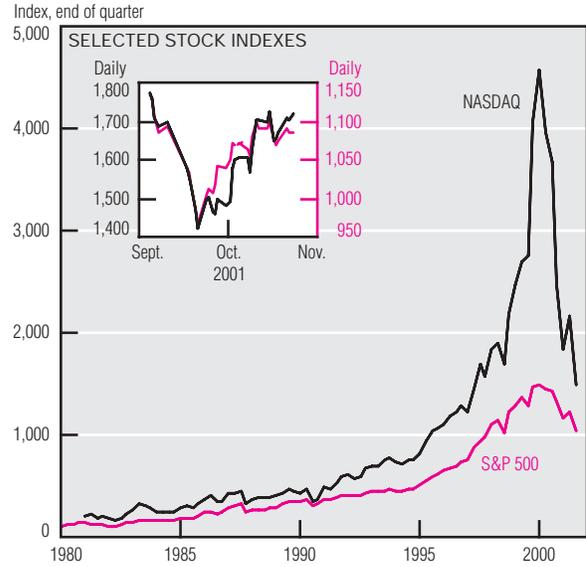
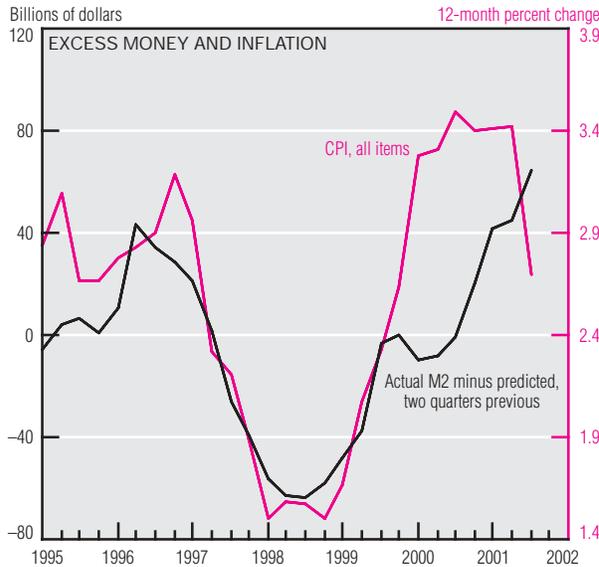
The spread between AAA corporate bond yields and BAA corporate bond yields has widened somewhat since September 11, but by then the spread already had been widening for almost two years. Companies that are rated below investment grade—airlines being perhaps the most highly publicized—continue to be downgraded at a higher rate than

investment-grade firms. After plunging in the week following the attacks, airline bonds stabilized and even rebounded slightly. Prices of insurance companies' bonds dropped less dramatically and are back to their pre-September 11 levels. The airline industry is relatively worse off in that added cost pressures are joined with reduced travel demand.

Growth rates of monetary aggregates, both broad and narrow, surged during September in the wake of the

(continued on next page)

Money and Financial Markets (cont.)



a. Stock valuation is calculated as the annualized operating earnings per share divided by the 10-year constant maturity Treasury bond yield. Dashed lines indicate earnings estimates provided by Standard and Poor's.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Releases*, "Money Stock and Debt Measures," H.6, and "Flow of Funds Accounts of the United States," Z.1; Federal Reserve Bank of Cleveland; Standard and Poor's; Bloomberg Financial Information Services; and the *Wall Street Journal*.

terrorist attacks. M3 spurred as asset owners accumulated transaction deposits and shifted into both retail and institutional money funds. The Federal Reserve supplied an enormous increase in bank reserves. The extraordinary scale of that action can be seen by comparing excess reserves (reserves not needed to meet reserve requirements) supplied during September 2001 to those supplied in the months leading up to the century date change. Estimates show October excess reserves and the monetary

base reverting to more normal levels as the Fed drains excess reserves from the banking system.

However, October data still do not show monetary policy exerting much of an effect on the monetary aggregates. Recent cuts in the fed funds rate will lead to reductions in their opportunity costs, so money growth will probably accelerate. So far, though, the increase in excess money growth (the excess of actual money over that predicted by a money demand model adjusted for the 1990s

shift in velocity) has not been reflected in rising inflationary pressures.

Many stock market indexes have rebounded after declining sharply following September 11. However, a broad stock market decline had begun long before that as the result of weakening economic conditions. By one measure, the stock market now is fairly valued. If consumers consider stock market gains in making spending decisions—a debatable assumption—the market's decline may affect future consumption adversely.