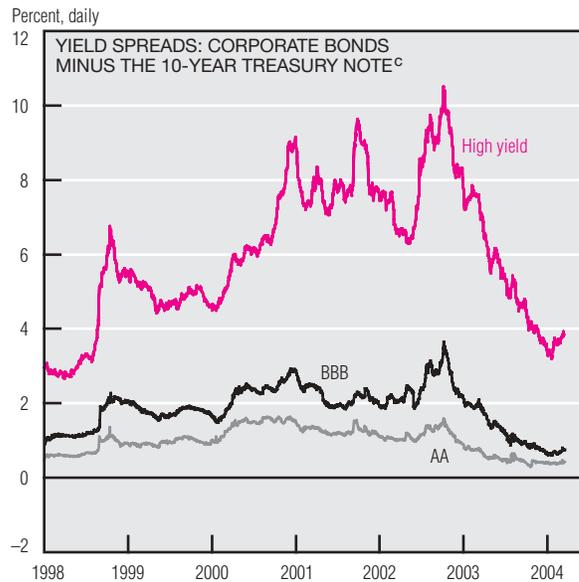
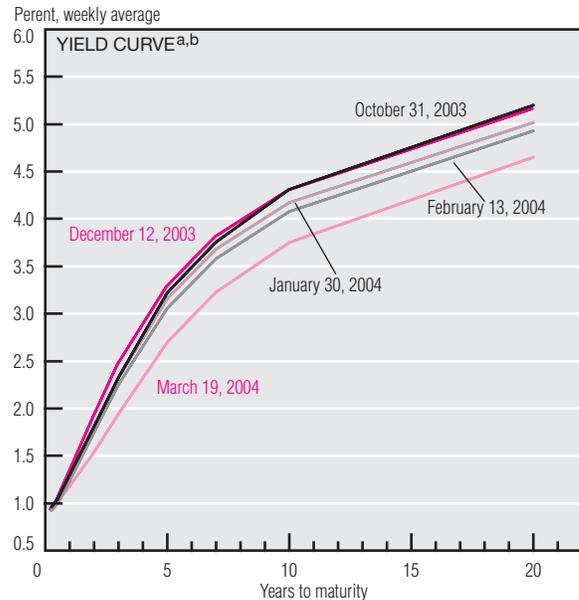
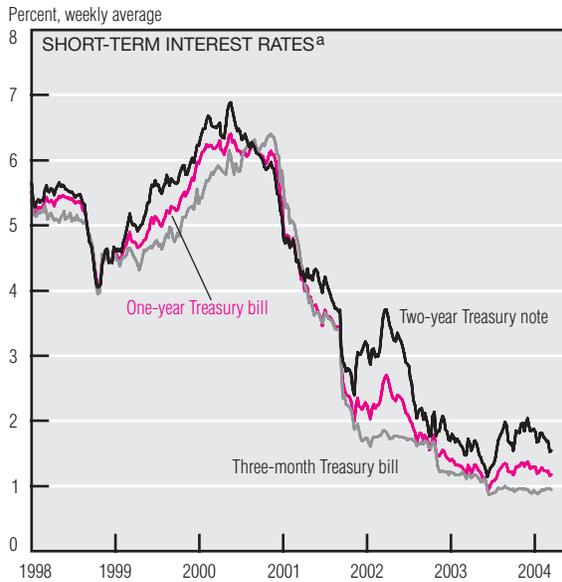


Money and Financial Markets



a. All yields are from constant-maturity series.

b. Average for the week ending on the date shown.

c. Merrill Lynch AA, BBB, and High-Yield Master II Indexes, each minus the yield on the 10-year Treasury note.

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

Market participants' inference that the FOMC has leeway to be patient is consistently reflected throughout the term structure of interest rates. Very short-term instruments, such as the three-month Treasury bill, have not budged from near 1% over the past year. The one-year and two-year bills declined very modestly in recent months after rising last summer. They remain very low by historical standards, suggesting the market's expectation that if tightening were to begin this year, it would occur later and in small increments.

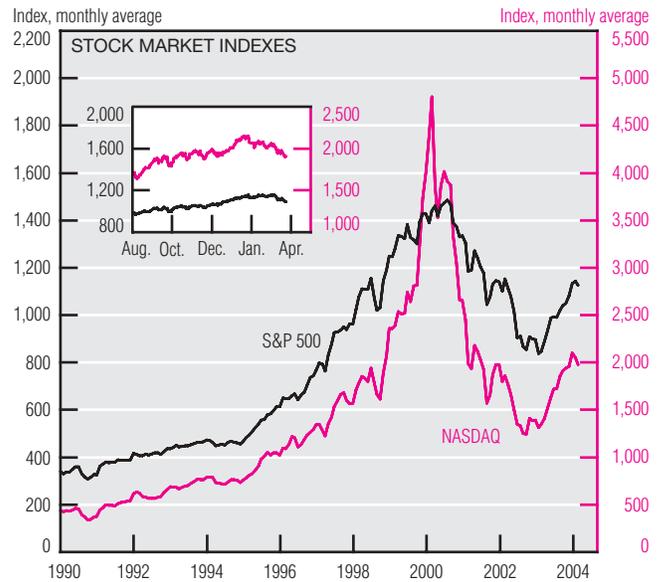
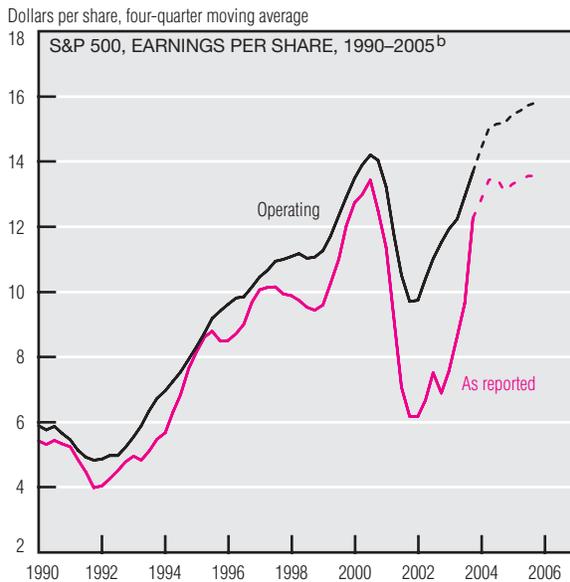
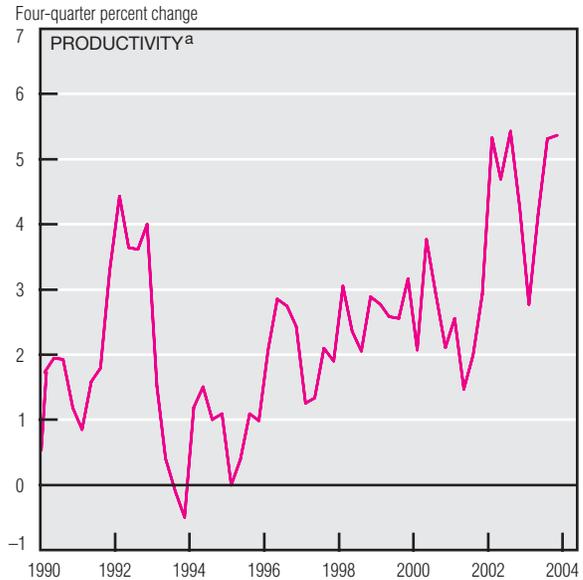
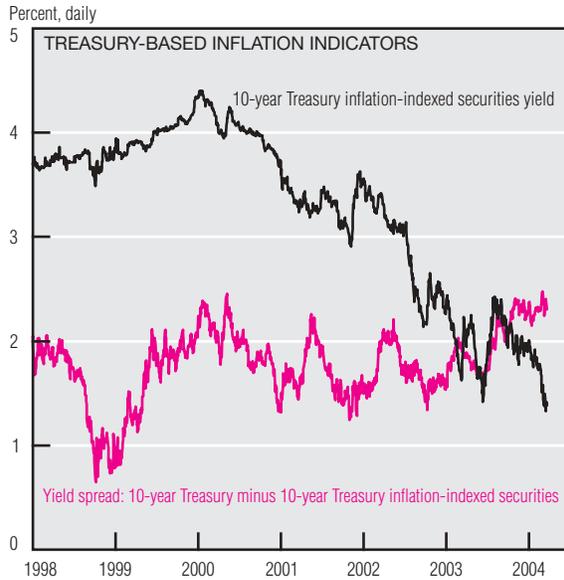
The declines in interest rates over the past six months increased with term to maturity. It is notable that long- and intermediate-term rates fell sharply in March, partly as a reflection of increased global uncertainty following the calamitous act of terrorism in Madrid. Such events typically induce a flight to quality, and U.S. Treasury instruments are regarded as among the safest investments in periods of turmoil. Yield spreads of corporate bonds over U.S. Treasuries, however, indicate that geopolitical concerns

have had only a limited effect on domestic securities.

It is somewhat unusual for long-term interest rates to fall significantly during a period of robust economic growth. The recent substantial flattening of the yield curve may reflect market confidence that the FOMC will—at the appropriate time—act preemptively to offset any potential inflationary pressures. Long-term nominal interest rates include a component that compensates the security holder for any expected inflation.

(continued on next page)

Money and Financial Markets (cont.)



a. Nonfarm business sector.

b. Earnings after 2003:IVQ are projections provided by Standard and Poors.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Standard and Poors Corporation; and Bloomberg Financial Information Services.

Thus, falling long-term interest rates often reflect expectations of stable or improving inflation conditions.

On the other hand, rates on Treasury inflation-indexed securities have fallen slightly faster than their nominal counterparts. Although such Treasury-based inflation indicators have drifted up modestly, most alternative indicators of inflation expectations have been well contained. There is scant evidence that the uptick in commodity prices—especially energy—has been passed through to consumers.

Nevertheless, it is widely understood that the real federal funds rate cannot be maintained at zero indefinitely without inducing an inflation increase. As Chairman Greenspan noted, “at some point” the FOMC will need to move its target to a more neutral position.

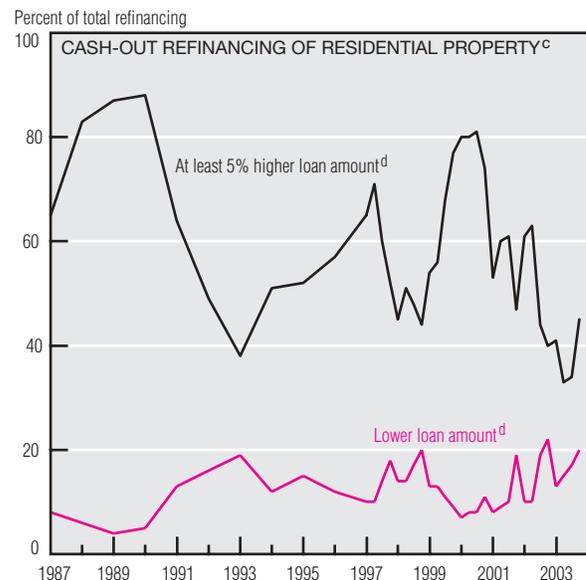
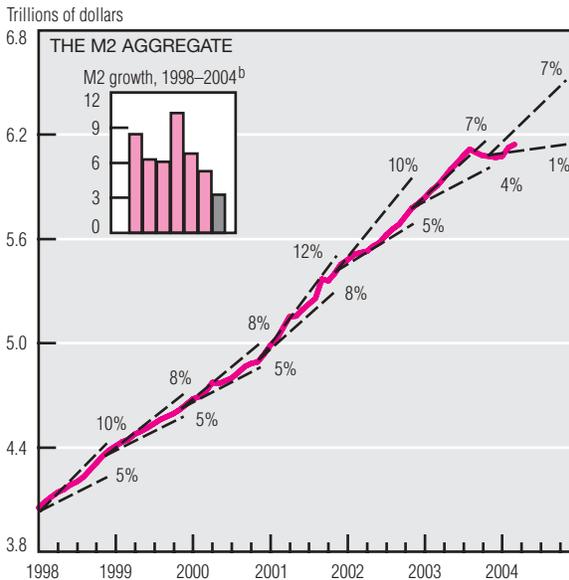
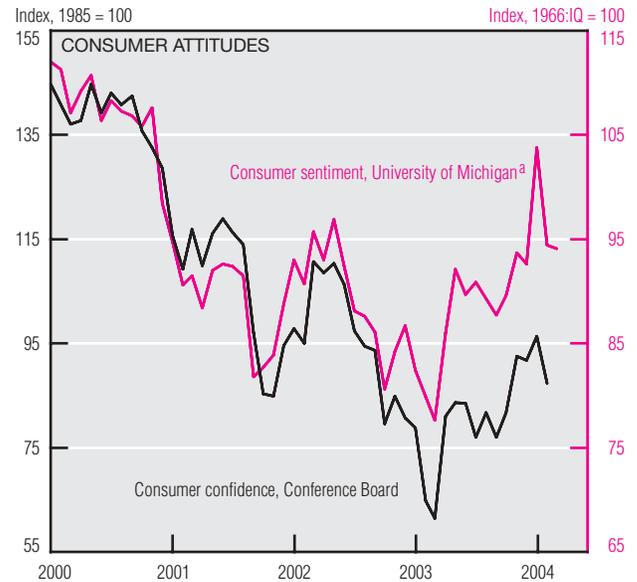
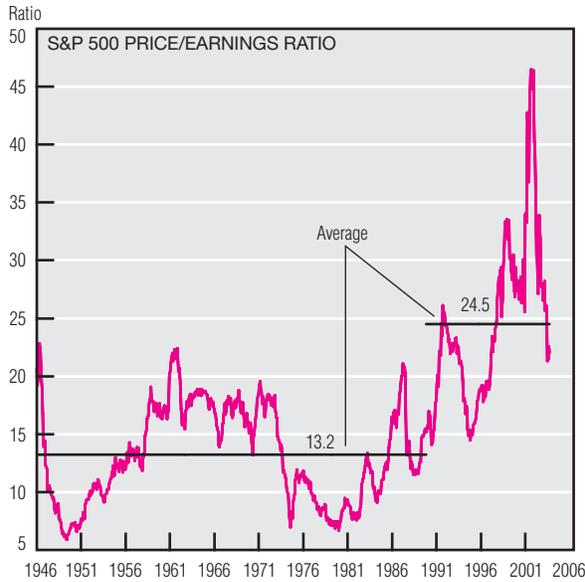
What is a neutral position? Economic theory suggests that over long periods of price stability, real interest rates will vary around a level approximately equal to the economy’s growth rate. Based on the

recent sharp acceleration in productivity, trend growth of the real economy is now estimated to be in the range of 3% to 4%. Futures markets suggest that it may take some time before policy is neutral again.

The belief in continued strong productivity growth is corroborated by analysts’ estimates of corporate earnings for the next two years. After falling for two years, corporate profits rebounded vigorously in 2003, providing support for a persistent

(continued on next page)

Money and Financial Markets (cont.)



a. Data are not seasonally adjusted.

b. Growth rates are calculated on a fourth-quarter over fourth-quarter basis. The 2004 growth rate for M2 is calculated on a March over 2003:1QV basis. Data are seasonally adjusted.

c. Annual data until 1997, quarterly data thereafter.

d. Compared with previous financing.

SOURCES: Board of Governors of the Federal Reserve System, "Money Stock Measures," *Federal Reserve Statistical Releases*, H.6; Federal Home Loan Mortgage Corporation; Conference Board; Standard and Poors Corporation; and University of Michigan.

stock market rally despite analysts' expectations that growth will slow through 2005.

Robust earnings growth in 2003 not only supported the stock market rally, but was also fast enough to allow the price-earnings ratio (P/E) to fall. P/E's are commonly used to gauge the soundness of stock market valuations. When they substantially exceed historical averages, valuations are often considered high.

The sharp fall in P/E's from their 2000 peaks is a welcome change because it reflects a return to valuations that are more consistent with current earnings. Moreover, given recent reforms in accounting practices and corporate governance, it is reasonable to expect that measures of corporate earnings are more firmly rooted in reality. Nevertheless, P/E's remain high by historical standards. The rebound in investor confidence seems to have exceeded the rebound

in consumer confidence, which remains below recent levels.

Finally, concerns about persistently slow money growth since mid-2003 were assuaged when the M2 monetary aggregate rebounded in the first quarter. The earlier marked slowdown in M2 resulted partly from the diminished escrow balances associated with a slowdown in mortgage refinancings. The recent drop in mortgage rates caused a surge in such balances and hence an acceleration in M2.