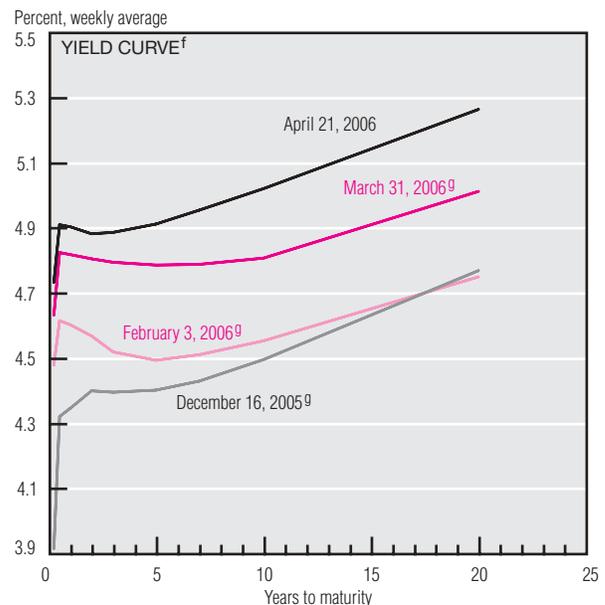
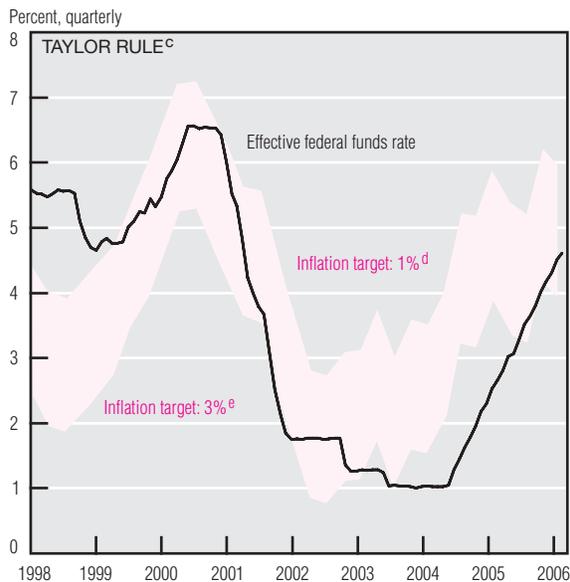
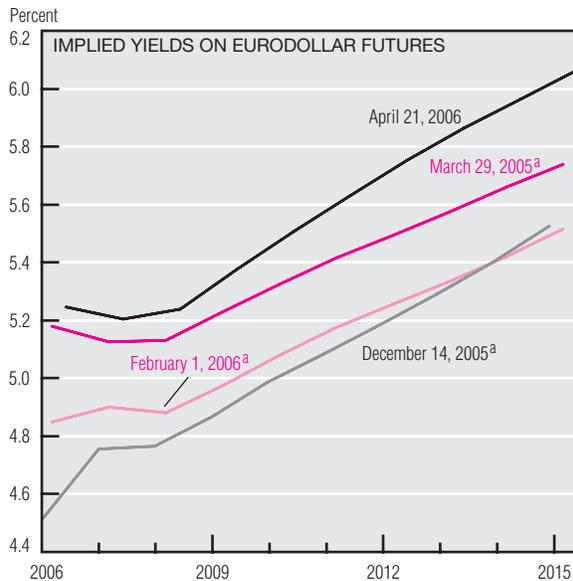


Money and Financial Markets



a. One day after the FOMC meeting.

b. Defined as the effective federal funds rate deflated by the core PCE.

c. The formula for the Taylor rule is taken from "How Useful Are Taylor Rules for Monetary Policy?" by Sharon Kozicki, Federal Reserve Bank of Kansas City, *Economic Review*, 1999:1Q, vol. 84, no. 2. The weight on inflation is 1.53, and the weight on the output gap is 0.27. The baseline Taylor rule assumes the inflation target is 1.50%, and the real interest rate is 1.75%.

d. Assumes an interest rate of 2.5% and an inflation target of 1%.

e. Assumes an interest rate of 1.5% and an inflation target of 3%.

f. All yields are from the constant-maturity series.

g. The Friday after the FOMC meeting.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; and Bloomberg Financial Information Services.

Market participants now place nearly even probabilities on a pause and a 25 bp funds rate hike in June. Federal funds futures foretell a further 50 bp increase in the funds rate by the end of October.

Implied yields on Eurodollar futures, which give a longer-run indication of the course of policy, tell a similar story—that the current round of policy tightening will end later in 2006

after a cumulative increase of 50 bp in the federal funds rate.

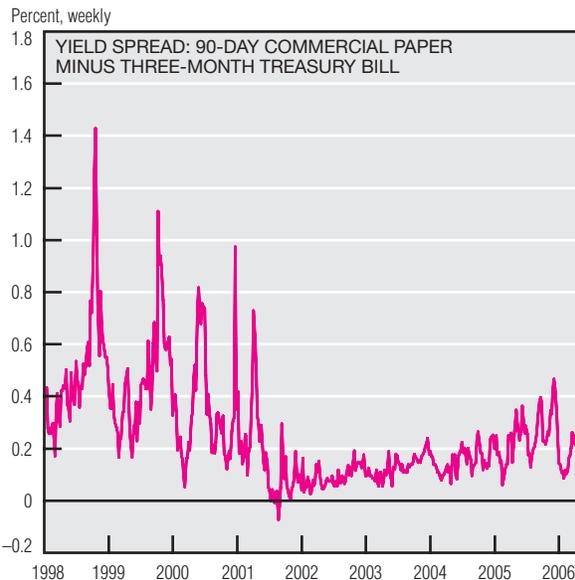
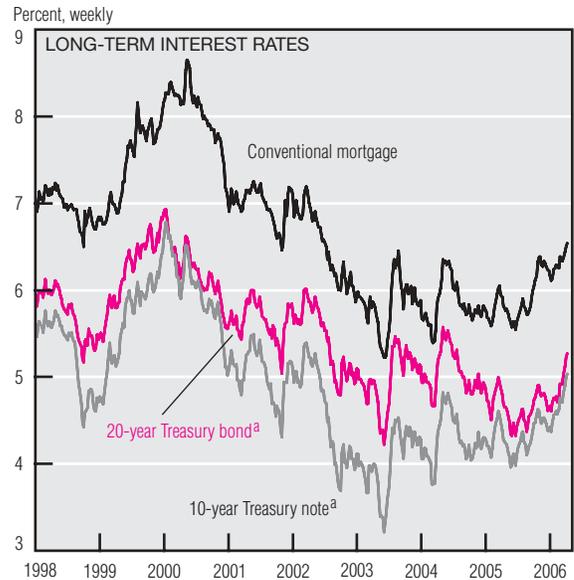
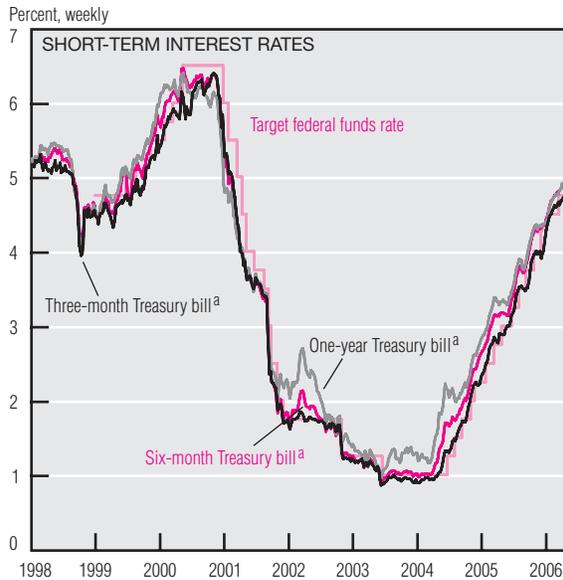
Since the current round of tightening began in June 2004, the real (inflation-adjusted) fed funds rate has increased more than 370 bp. The latest increase in the funds rate moves it toward the middle of the range suggested by the Taylor rule, which considers the rate a reaction to a weighted average of inflation, target inflation, and economic growth.

The minutes of the FOMC's March meeting indicate that many members view the rate as approaching the neutral level. However, as Federal Reserve Bank of Chicago president Moskowitz noted on March 7, being in the neutral range does not rule out future rate hikes.

The inversion of the yield curve observed earlier this year has nearly disappeared. The curve remains mildly

(continued on next page)

Money and Financial Markets (cont.)



a. Yields from constant-maturity series

b. 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.

inverted only for maturities of six months through three years, with the three-year rate only 2 bp less than the six-month rate. In recent months, however, many Federal Reserve officials have noted that yield curve inversions do not necessarily portend a downturn in economic activity.

Short-term rates have moved in step with funds rate increases. Since the current round of policy tightening began in June 2004, Treasury rates have moved up more than 320 bp at the short end of the maturity

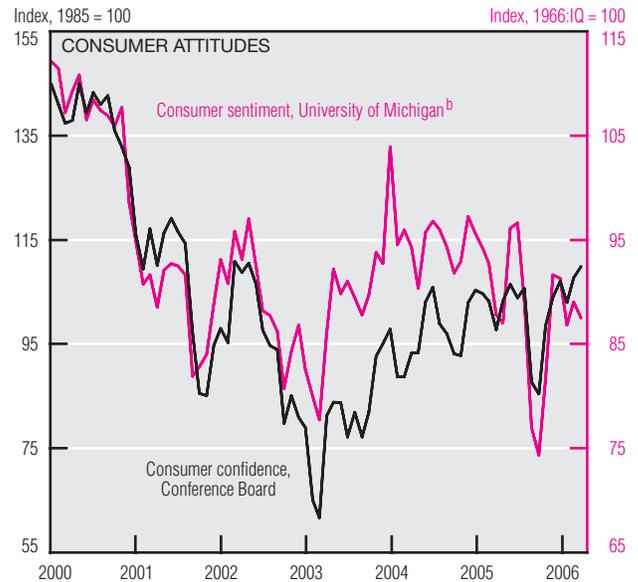
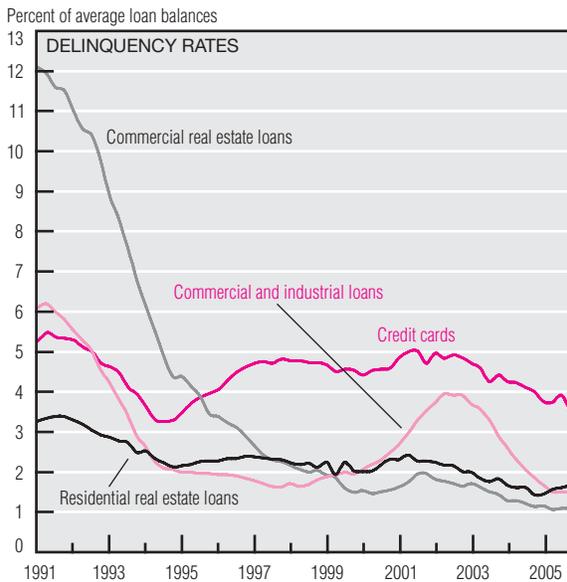
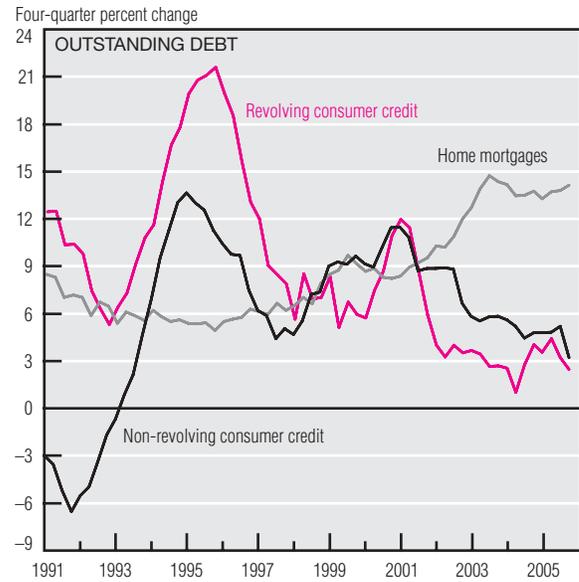
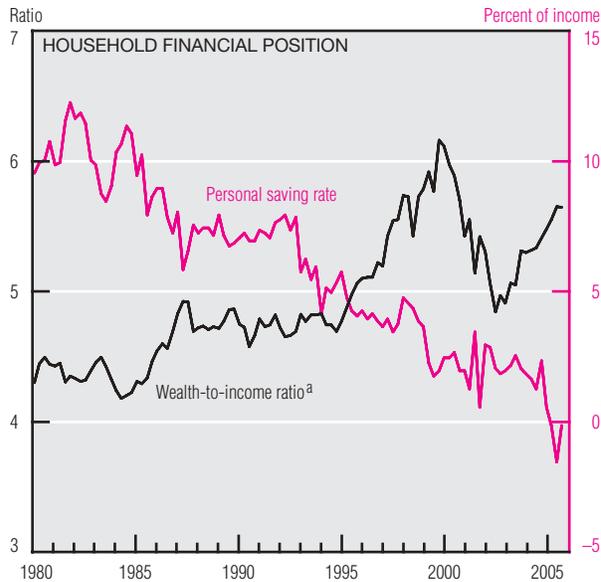
spectrum. Long-term Treasury yields rose more than 20 bp in April, causing a noticeable steepening of the yield curve at the long end. In fact, 10- and 20-year Treasury rates both rose above 5%, their highest level in more than 18 months.

Although long-term rates on conventional mortgages have trended upward, increasing more than 80 bp since September 2005, home mortgage debt growth remained robust in 2005:IVQ. However, mortgage applications and housing starts have slowed down during the last month.

The risk spreads on corporate bonds indicate investors' willingness to take on risk. To derive the spread, we compare the yield on corporate bonds with that on a safe asset (Treasury debt). After plummeting in late 2005 and early 2006, risk spreads on short-term corporate debt have risen modestly in recent months. The spread between 90-day commercial paper and three-month Treasury bills is more than 10 bp higher than at the beginning of February. Risk spreads on longer-term AA- and BBB-rated corporate debt have been flat so far

(continued on next page)

Money and Financial Markets (cont.)



a. Wealth is defined as household net worth; income is defined as personal disposable income.

b. Data are not seasonally adjusted

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System, "Flow of Funds Accounts of the United States," *Federal Reserve Statistical Releases*, Z.1; University of Michigan; and the Conference Board.

this year, whereas risk spreads for high-yield corporate debt have actually fallen.

For the third consecutive quarter, the saving rate was negative in 2005:IVQ. Monthly data indicate that it remained negative through February 2006. However, the wealth-to-income ratio continues the upward trend that began in late 2002.

Outstanding home mortgage debt continued to grow at double-digit annual rates in 2005:IVQ. Since the first quarter of 2002, mortgage debt has increased at annual rates above 10%.

Consumer credit growth, both revolving and non-revolving, declined substantially in the last quarter of 2005. Auto sales slowed markedly in the first part of the year, dampening growth in non-revolving consumer credit. For February 2006, overall consumer credit growth was 2.55% year over year, its lowest growth rate since 1993.

Despite high and rising levels of consumer debt, delinquency rates on consumer loans remained low. However, delinquency rates for residential real estate loans ticked up slightly in 2005:IVQ.

In April, the Conference Board's Index of Consumer Confidence unexpectedly rose 2.1 points to 109.6, its highest level since May 2002. Most of the increase resulted from a rise in the present conditions component of the index, although the future expectations component also rose. However, consumers' buying plans fell off: Fewer intended to buy major appliances or homes over the next few months. The University of Michigan Consumer Sentiment Index declined in April because of a drop in the index's expectations component.