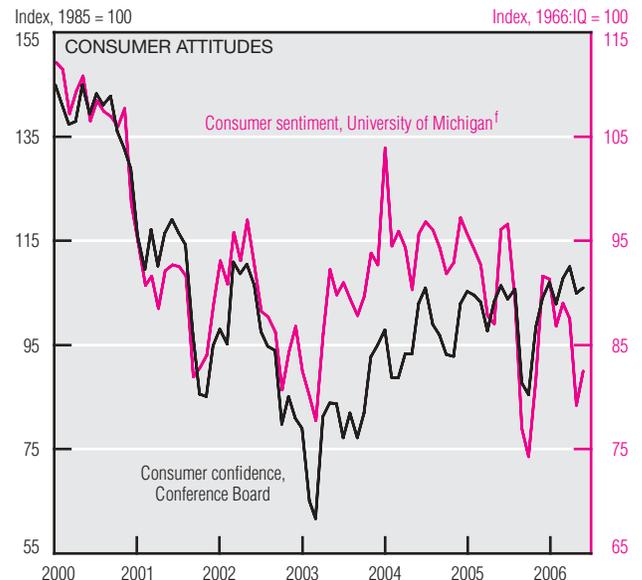
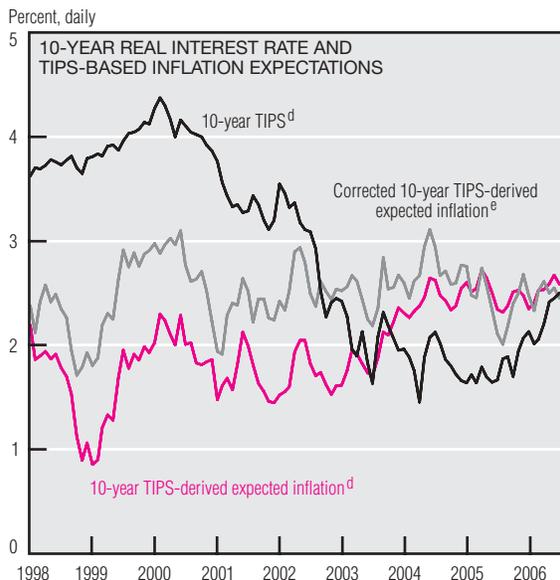
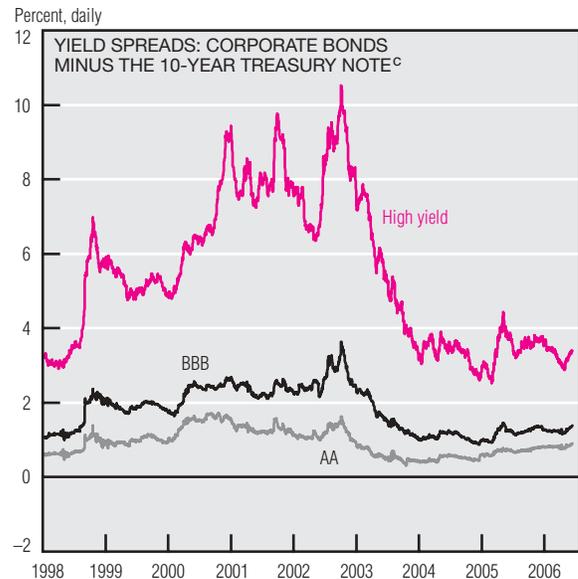
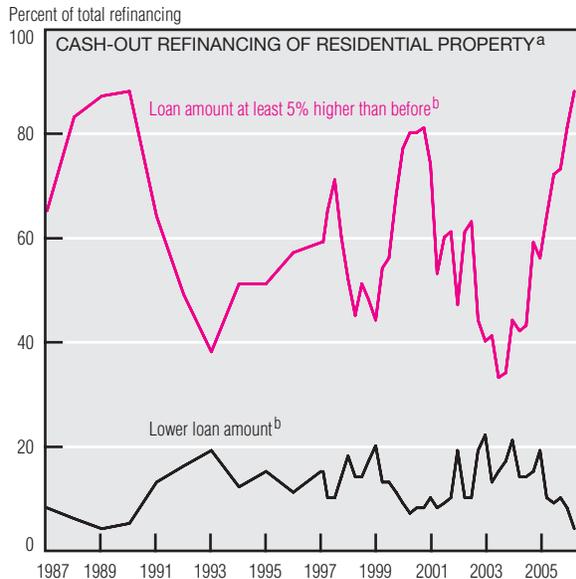


Money and Financial Markets



a. Annual data until 1997; quarterly data thereafter.

b. Compared with previous financing.

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

d. Treasury inflation-protected securities.

e. Ten-year TIPS-derived expected inflation adjusted for the liquidity premium on the market for the 10-year Treasury note.

f. Data are not seasonally adjusted.

SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; Federal Home Loan Mortgage Corporation; University of Michigan; Conference Board; and Bloomberg Financial Information Services.

Although long-term interest rates have trended upward from their 2003 trough, they remain low by historical standards. Some view this as the consequence of a savings glut in developing countries, especially in Asia.

Low mortgage rates have been a key stimulant in the housing boom, which has been reflected in a surge in housing prices over recent years. The modest rise in mortgage rates is ultimately expected to be associated with a cooling in spending on housing and hence housing prices. If

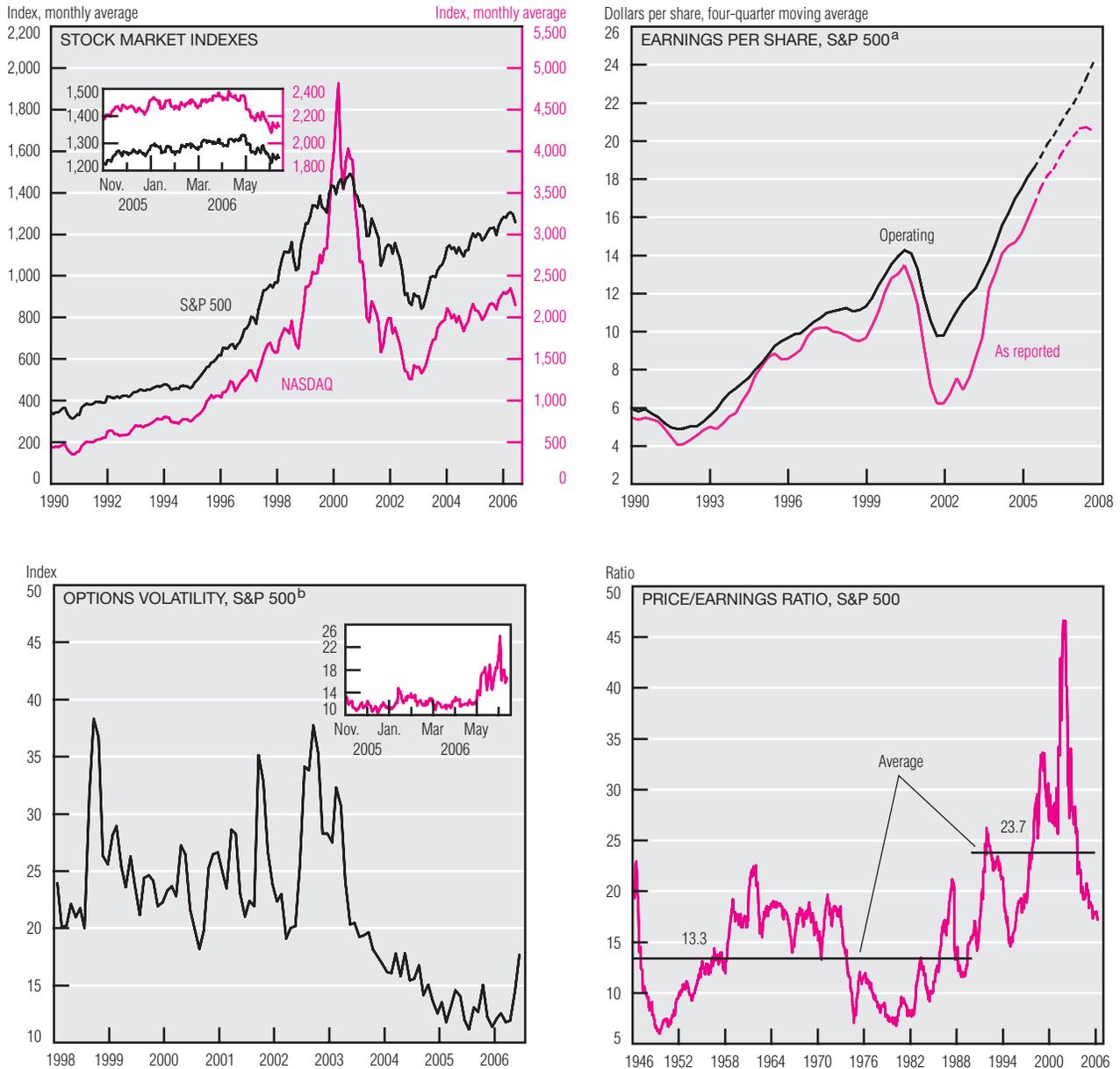
foreign savings are abruptly curtailed, however, interest rates could start to rise more quickly.

Moreover, some analysts worry that housing prices may have become unsustainable, especially in coastal cities, where those prices have risen the most sharply. In such areas, the housing market could fall off more swiftly than anticipated. Together, persistently low mortgage rates and rapidly rising housing values have enabled households to refinance their homes at higher loan values.

The difference between old and new loan amounts—known as cash-out refinancing—has provided a deep well of cash to finance robust consumer spending in recent years. Indeed, more than 80% of residential refinancing in the first quarter of 2006 resulted in a loan amount that was at least 5% higher than before. Such a source of funds cannot persist if mortgage rates continue to rise and housing prices cool. Thus, consumer spending, which like housing

(continued on next page)

Money and Financial Markets (cont.)



a. Dashed lines indicate the forecast as of June 22, 2006.

b. Chicago Board Options Exchange Volatility Index (VIX). Monthly data.

SOURCES: Standard and Poor's Corporation; Chicago Board Options Exchange; and Bloomberg Financial Information Services.

is expected to slow, is also vulnerable to rapidly deteriorating financial conditions.

Market commentary cited the minutes of the FOMC's May meeting, which noted that "participants discussed in some detail inflation expectations—a potentially important factor influencing future inflation trends ... Measures of inflation compensation based on the difference between yields on nominal Treasury securities and inflation-indexed issues had edged higher. It was possible, though, that investors' uncertainty regarding inflation prospects, not just

inflation expectations themselves, had risen. On balance, participants judged that inflation expectations had risen somewhat—a development that would have to be taken into account in policymaking and warranted close monitoring—but remained contained."

Market reaction in the period between FOMC meetings seemed to validate these views. Market-based estimates of expectations about the future path of policy reacted consistently with the revelation of factors affecting the inflation outlook. Market-based estimates of inflation expectations actually fell in response

to unfavorable inflation news, suggesting a belief that the FOMC would do whatever was necessary to contain inflation expectations.

The market's view that additional policy firming would be needed roiled an already unsettled equities market. Low and stable bond rates have been good for equities prices, which are fundamentally based on the discounted present value of future earnings. Higher, more uncertain interest rates imply a lower discount factor and hence lower equities prices. Equities prices fell sharply during the intermeeting period.