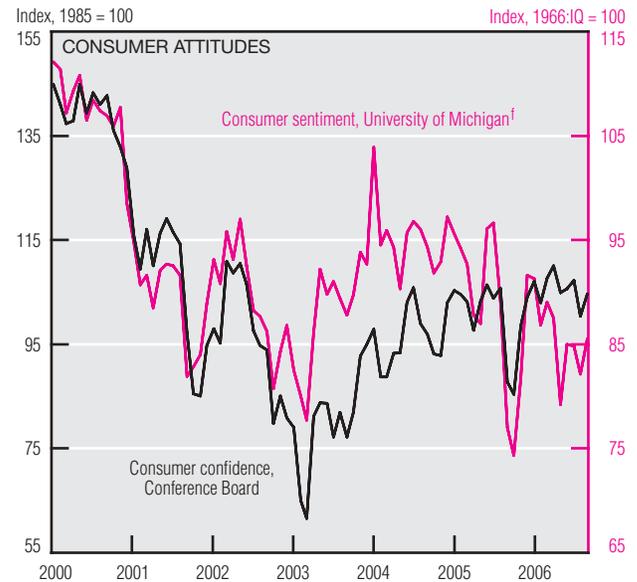
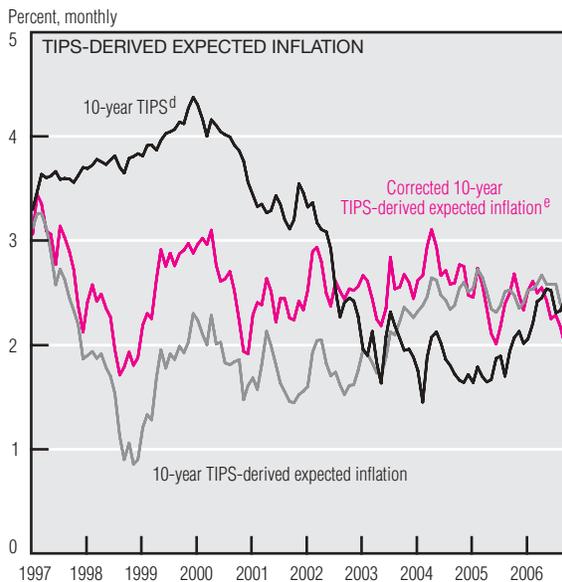
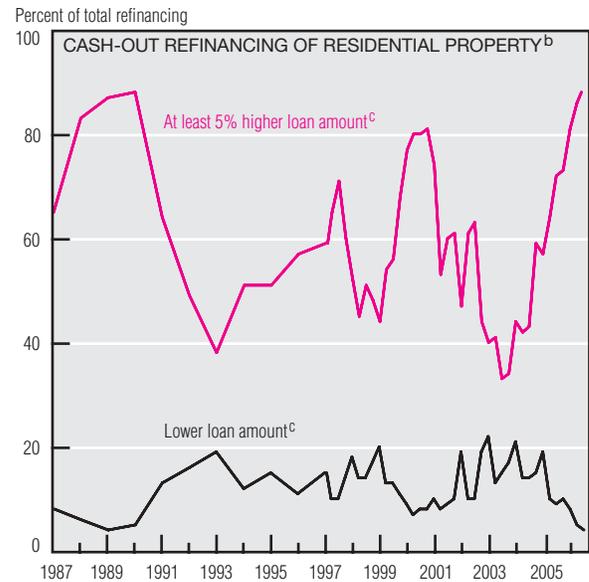
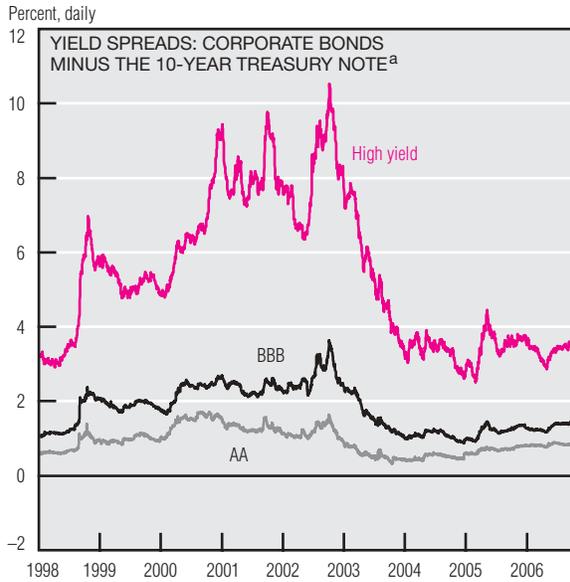


Money and Financial Markets



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

b. Annual data until 1997; quarterly data thereafter.

c. Compared with previous financing.

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: Federal Reserve Board, "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 they have trended up from their 2003 trough, long-term interest rates remain low by historical standards. Moreover, yield spreads between risky assets and safe ones, such as the 10-year Treasury note, have been small, a sign of investors' confidence in financial conditions.

Low mortgage rates, a key stimulus in the housing boom, were reflected by a surge in housing prices over recent years. The modest rise in mortgage rates has been associated

with a cooldown in housing expenditures. In many markets, housing prices have declined over the past year.

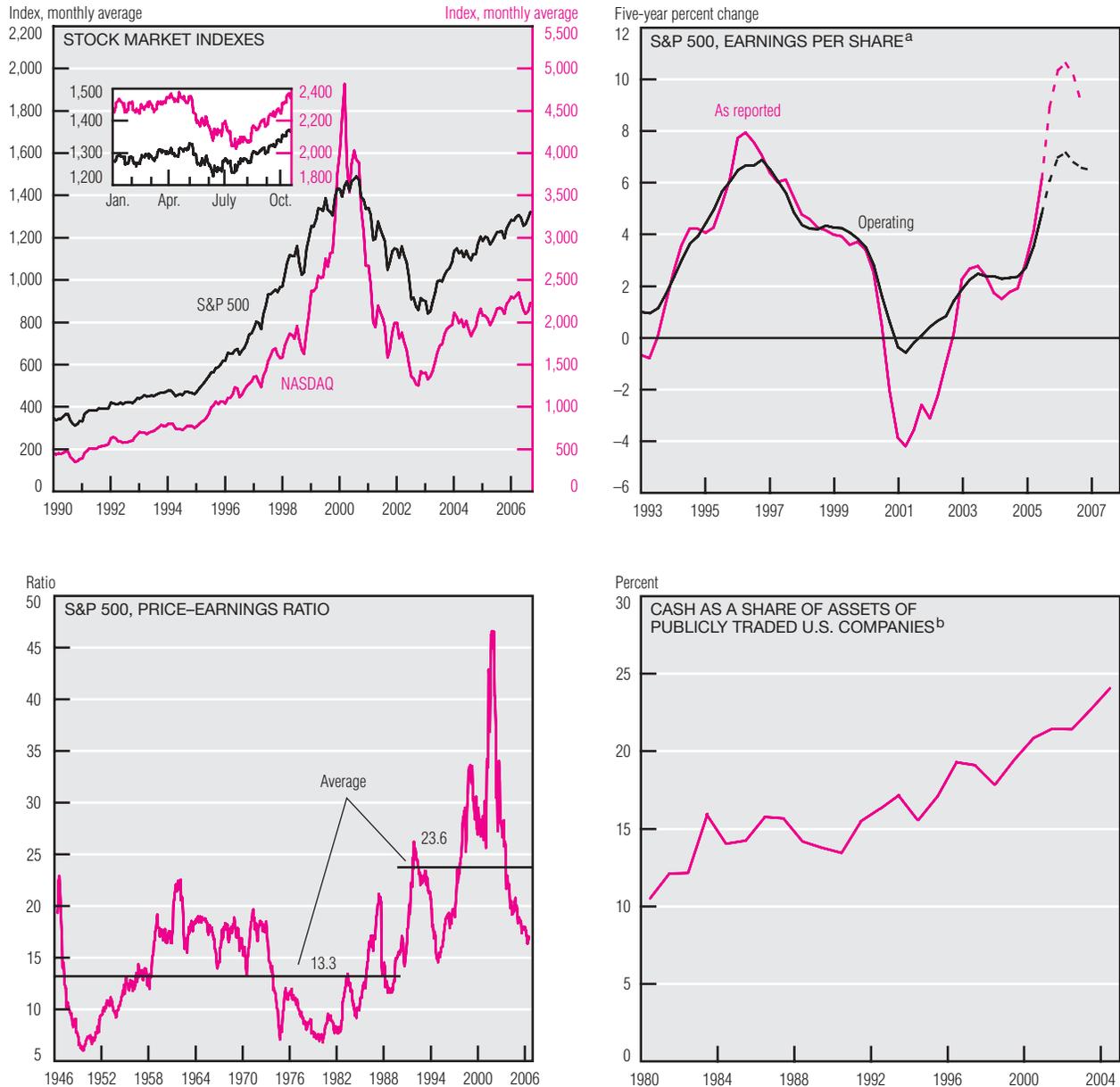
Together, persistently "low" mortgage rates and rapidly rising housing values have enabled households to refinance their homes at higher loan amounts. The difference between new and old loan amounts—known as cash-out refinancing—has provided a deep well of cash to finance robust consumer spending in recent years. Indeed, about 90% of residential refinancing in 2006:IIQ resulted

in a loan amount at least 5% higher than the previous one.

Cash-out refinancing will probably not persist at recent levels if mortgage rates stabilize at higher levels and housing prices continue to fall. If this source of household funds were to shrink, consumers would be less able to finance the high spending levels of recent years. Thus, diminished liquidity could compound the effects of a housing decline on economic activity.

(continued on next page)

Money and Financial Markets (cont.)



a. Dashed lines indicate the forecast as of October 18, 2006.

b. Percent of total assets of U.S. companies held in cash and marketable securities. Excludes financial firms and utilities.

SOURCES: Standard and Poors Corporation; Chicago Board Options Exchange; Thomas W. Bates, Kathleen M. Kahle, Rene M. Stulz, "Why Do U.S. Firms Hold So Much More Cash Than They Used To?" National Bureau of Economic Research working paper; and Bloomberg Financial Information Services.

Concerns about a weakening economy figured in the Federal Open Market Committee's August decision to pause from the steady, "measured pace" policy of quarter-point rate hikes that it had been following for three years. Measures of inflation compensation based on the difference between yields on nominal Treasury securities and inflation-indexed issues have edged lower in recent weeks, suggesting that the pause in policy rate hikes is consistent with the FOMC's primary goal of achieving price stability.

Low and stable bond rates have been good for stock prices, which fundamentally are based on the present value of expected future dividends. Lower and more certain interest rates mean that equity holders discount future dividends by less, hence equities are valued more. Equity prices have risen sharply since early summer.

Another key stock-price fundamental—earnings growth—has been persistently strong, approaching rates not seen for a decade. In recent years, earnings growth has exceeded the run-up in equities prices, as evidenced by the declining price-earnings ratio.

Strong earnings growth has helped firms build cash relative to other assets. Whereas some analysts see high cash holdings as a positive for future equities prices, others argue that additional cash is needed because cash flows have become more variable. Firms may be reluctant to use this additional cash for dividends until they are confident that the cash-flow increase is permanent. Thus, the rise in cash holdings may not portend stronger dividend growth or higher stock prices.