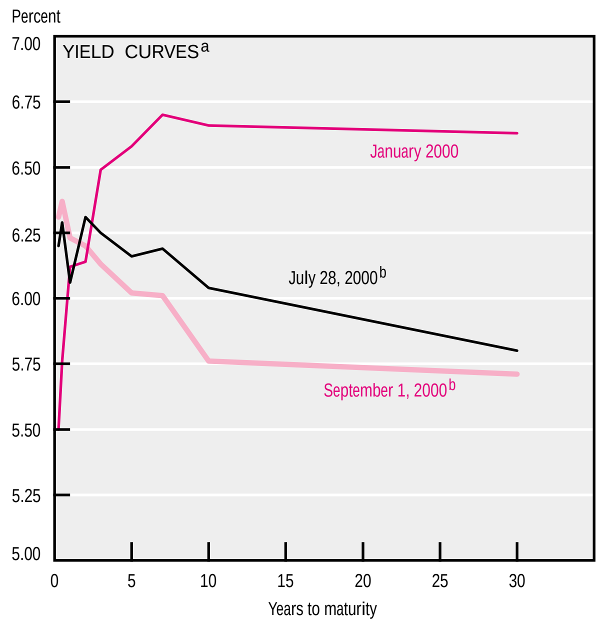
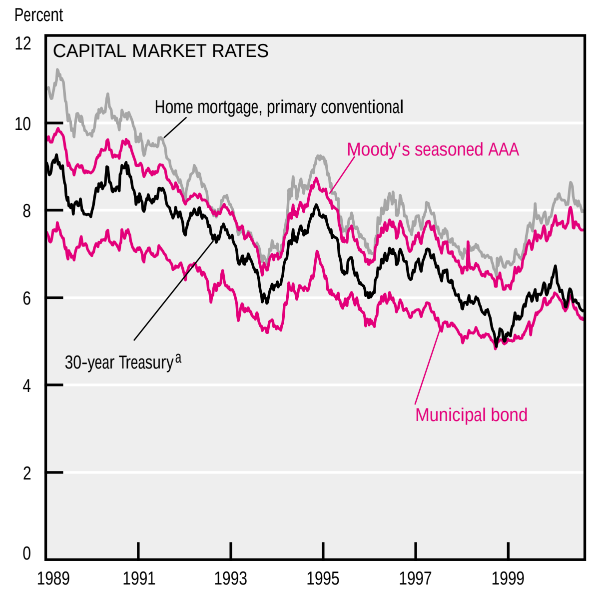
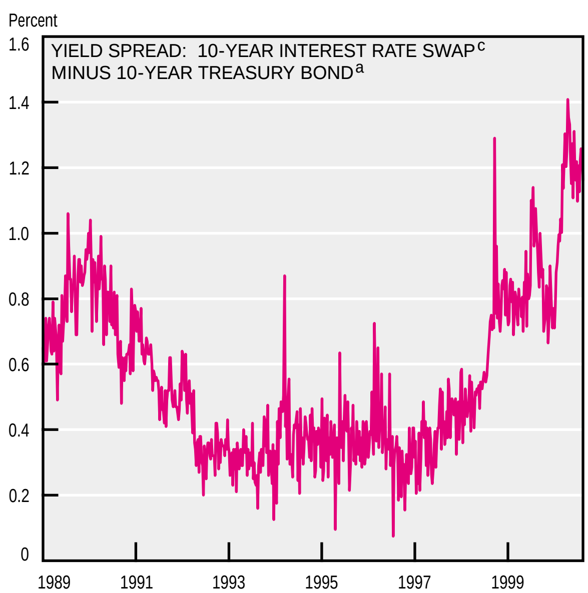
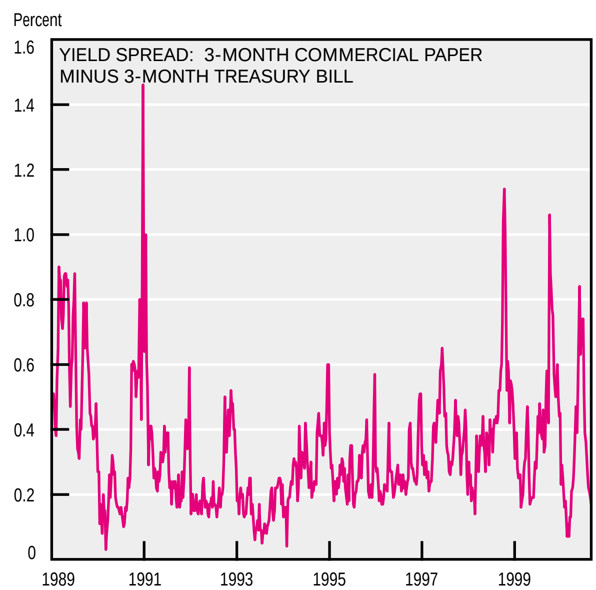
Interest Rates









a. All yields are from constant-maturity series.
b. Average for the week ending on this date.
c. Quote for semiannually fixed rate versus 3-month U.S. $LIBOR.
SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; and Bloomberg Financial Information Services.

The yield curve has inverted further since last month, with yields on maturities of two years and above falling, and those below two years rising. The entire curve is inverted, except for 3- and 6-month bills.

The Treasury yield curve gets most of the attention because it acts as a risk-free benchmark for the financial market, but information abounds in the yields of risky maturities as well. Thus, among longer-term rates, the drop in yields since January has been much less pronounced than for 30-year Treasuries. Treasury rates apparently are having less impact on mortgage rates than in the past. Similarly, the yield spread between Moody's AAA bonds and long bonds has increased from 114 basis points (bp) in January to 184 bp now.

The increased spread also shows up at the 10-year maturity, between interest rate swaps and Treasuries. This number is alarming if it retains its traditional significance as a measure of risk in the financial markets, reaching levels not seen since the Russian default and the collapse of Long Term Capital Management.

Is the market really so fearful? Two considerations argue that it is not: First, lower long-term Treasury yields may be heavily influenced by supply reductions. If this, rather than a flight to quality, explains why safe rates have dropped while risky rates have remained steady, then there is less cause for concern. Second, shorter maturities, such as three months, where supply considerations have less impact, show risk spreads at a low level.