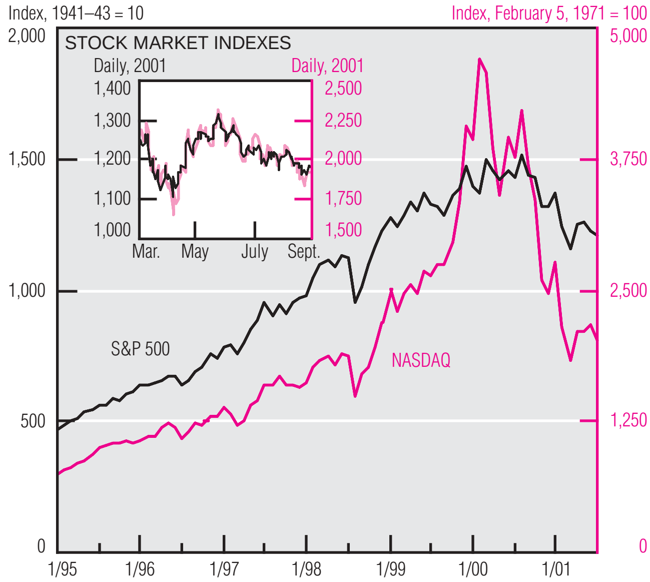
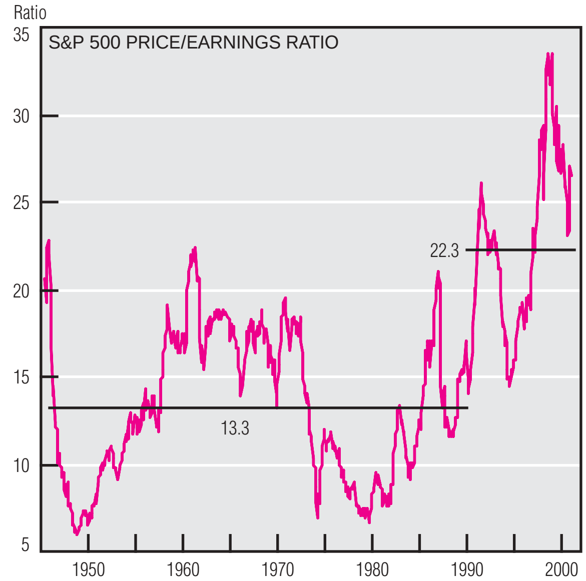
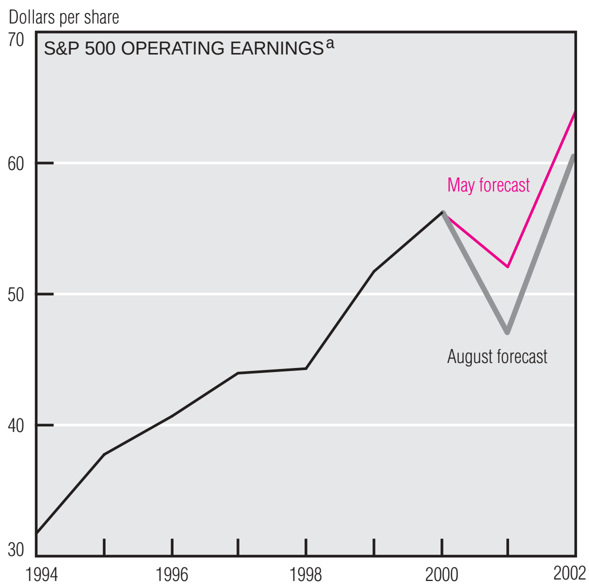
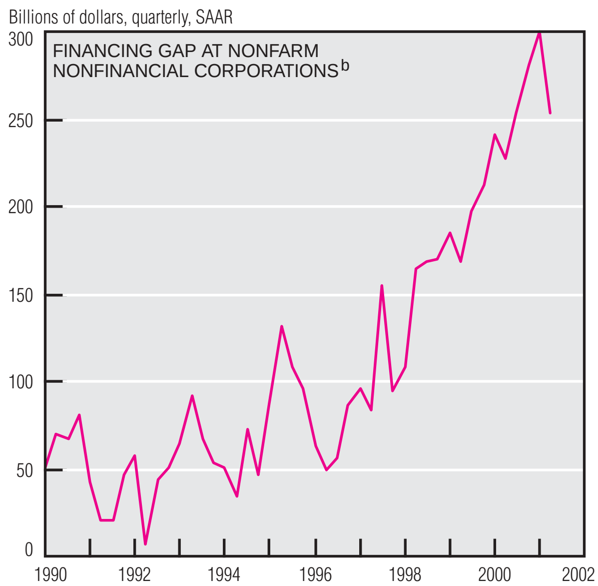
Money and Financial Markets









a. Forecasts are earnings estimates provided by Standard and Poors.
b. The financing gap is the difference between capital expenditures and internally generated funds.
SOURCES: Board of Governors of the Federal Reserve System, *Flow of Funds Accounts of the United States*; Standard and Poors; and Bloomberg Financial Information Services.

Despite the Federal Open Market Committee's aggressive three-percentage-point reduction in the intended funds rate since January, hopes for an incipient resurgence in economic activity appear to be slipping. Mixed signals from incoming data, which fail to confirm a broad rebound in economic activity, are fostering greater uncertainty about the timing of the expected upturn. While consumer and housing sectors have held up surprisingly well and inventories have been worked down, financial markets have been listless over the summer months.

The uncertain outlook is most evident in the stock market. Because equity markets are forward looking, stock prices typically anticipate upturns, moving in advance of an accelerating economy. In April, stock prices rose substantially, appearing to support the optimistic view that the economy would accelerate during the second half of the year. When subsequent indicators failed to confirm this view, the stock market rally stalled and equity prices retraced much of their advance. Despite the decline in stock prices, the price/earnings ratio still remains above its average rate since 1990.

A fundamental drag on the stock market has been the persistently negative news on corporate earnings. Operating earnings at S&P 500 companies turned out weaker than expected in the second quarter—down one-third from their levels in the same quarter last year. The expected path of operating earnings in 2001 and 2002 has been revised down substantially over the summer months. Nevertheless, a sharp rebound is projected for 2002 earnings.

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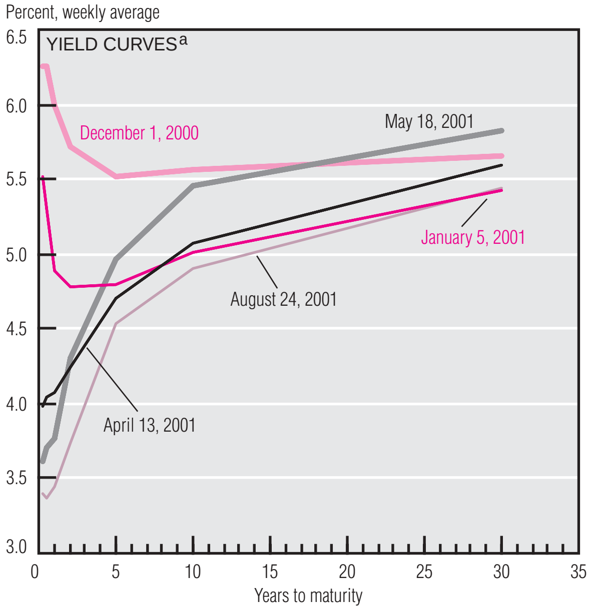
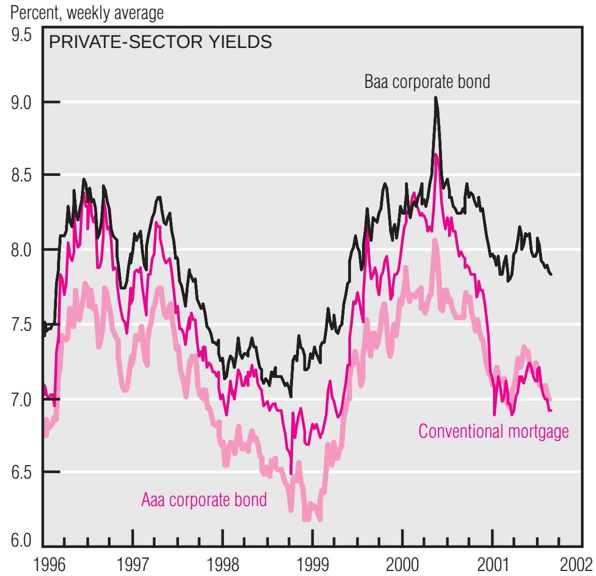
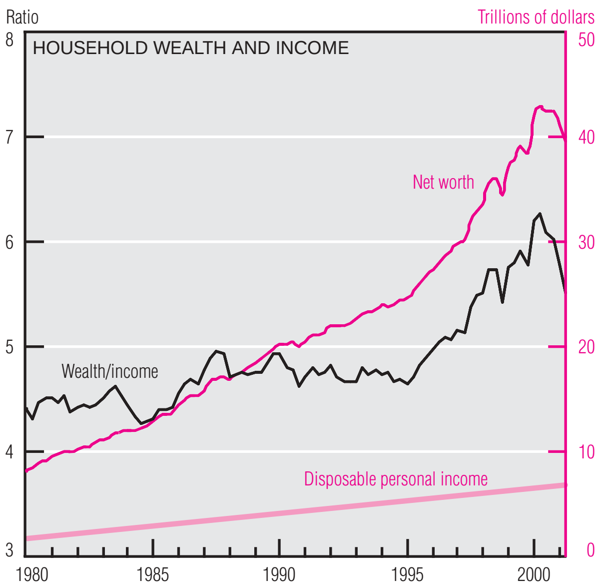
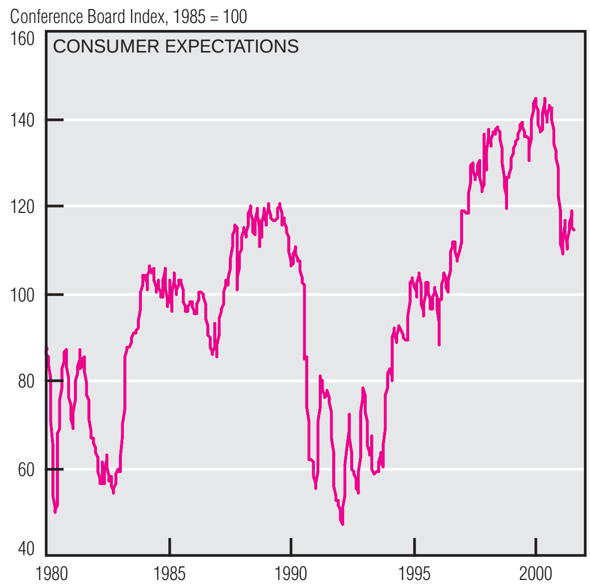
Money and Financial Markets (cont.)









a. Constant maturity.
SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases,* H.15 and *Flow of Funds Accounts of the United States*; and The Conference Board.

One explanation for this optimism about 2002 may derive from an expected rebound in investment in new technologies.

The primary source of weakness in the economy is the sharp deceleration in business fixed investment. Demand for capital equipment slowed substantially as firms faced the prospect of diminishing profits. Because earnings are a major source of financing for capital expenditures, their weakness is reflected in a persistently high financing gap—the difference between investment and internally generated funds. Although investment has declined more than profits, the need for external funds remains strong. Corporations have responded by cutting back on cash-financed mergers and equity repurchases, but these measures have not fully offset the effects of diminished profits.

At the same time, short-term funding markets have become less hospitable. Defaults by two utility firms early in the year cast a pall over the commercial paper market, which often pulls back during periods of high uncertainty. Commercial banks reported that they have tightened their standards and terms on short-term loans. To meet their financing needs under these conditions, businesses have borrowed heavily in bond markets while paying down both C&I loans at commercial banks and commercial paper. Strong demand for external funds has thus buffered longer-term market rates in the face of funds rates reductions. As a consequence, the yield curve has steepened.

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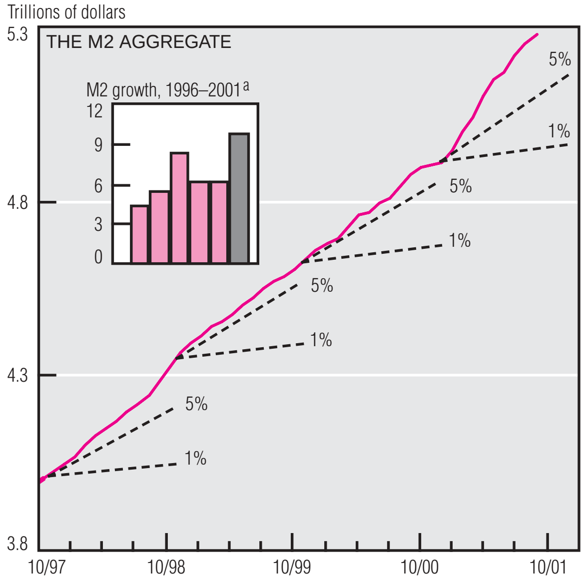

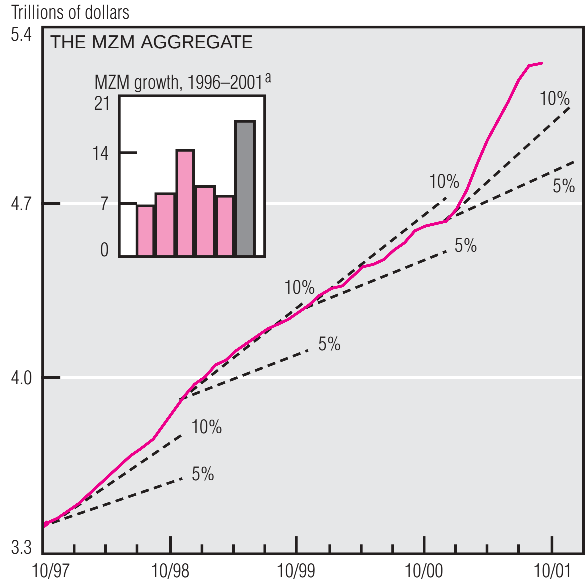

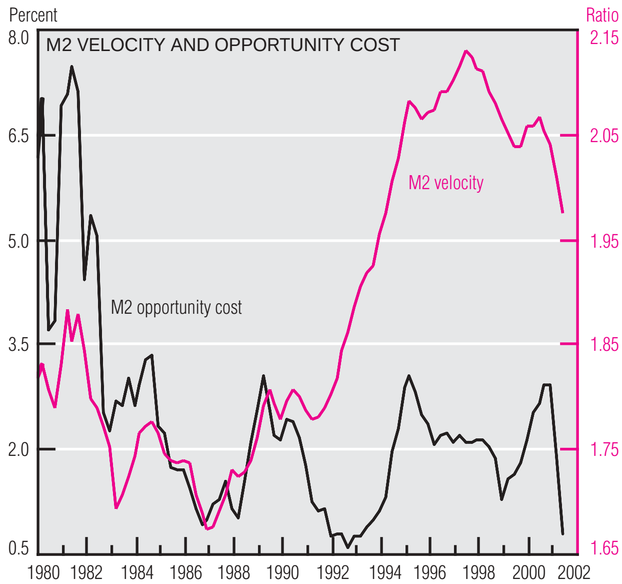

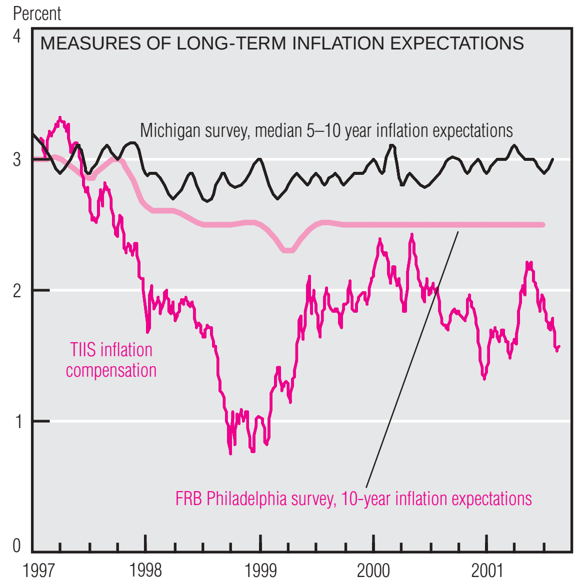

a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. The 2001 growth rates for M2 and MZM are calculated on an estimated August over 2000:IVQ basis. Data are seasonally adjusted.

b. TIIS's inflation compensation is the rate of inflation at which the price of the 10-year Treasury inflation-indexed security equals the value of a portfolio of zero-coupon securities that replicates its payments; data for this measure are end of week.

NOTE: Last plots for M2 and MZM are estimated for August 2001. Prior to November 2000, dotted lines for M2 are FOMC-determined provisional ranges. Subsequent dotted lines for MZM represent growth rates and are for reference only.

SOURCES: Board of Governors of the Federal Reserve System; Federal Reserve Bank of Philadelphia; and University of Michigan.

Although mortgage rates have moved little in recent months, they are relatively low by historical standards, inducing refinancings and strong housing demand. Refinancings have afforded the consumer spending power, which has helped maintain a surprising robustness in consumption expenditures despite the decline in stock market wealth. Even after the equity decline, however, the household wealth-to-income ratio remains higher than it was before the late-1990s run-up. Households apparently consider their longer-term stock gains when assessing their permanent income.

A surprising decline in consumer confidence, reported in late August, gave markets pause. With no apparent liftoff in sight, investors seem concerned that falling consumer confidence could undermine the only sources of current economic growth—personal consumption and housing demand.

On the other hand, many analysts believe that monetary policy has been sufficiently, if not aggressively, stimulatory. They point to strong growth in the monetary aggregates M2 and MZM, which is primarily a reflection of past interest rate declines that have reduced the opportunity cost of holding these funds. In their view, policy actions affect the economy with a lag, so there is a risk of moving too far too fast. The decline in Treasury inflation-indexed securities' inflation compensation and the relative stability of survey measures of long-term inflation expectations offer some comfort. Policy actions have not induced an increase in inflationary expectations.