The recent financial environment, in which the overnight real interest rate has been near zero, was initially associated with a general decline in interest rates across all maturities. The three-month Treasury bill still hovers near its longer-term low, but most other rates began to rise in early summer, after the Federal Open Market Committee surprised the market with a smaller-than-expected rate cut. The yield curve steepened sharply after the Committee’s June 25 policy statement, with long-term rates jumping around 100 basis points in the month following. Since then it has stabilized, backing off only slightly at the longer maturities.

The initial decline in interest rates was associated with a stream of economic data that revealed a sputtering economic recovery and a decline in employment. No doubt the hesitant economic expansion was largely a reflection of the uncertainty associated with the anticipation and prosecution of the Iraq war. Although the conflict’s resolution may have been less complete than was hoped, economic expansion exploded in the third quarter, when GDP increased at an 8.2% annual rate.

Consumers were not reluctant to spend the funds made available by tax cuts; more importantly, businesses showed a greater willingness to expand investment, especially in the purchases of information technology equipment. Despite the good economic news associated with a backup in interest rates, especially at the longer end, the outlook appears to remain prudently cautious. On the positive side, yield spreads of corporate bonds over Treasuries have continued (continued on next page)
Money and Financial Markets (cont.)

to fall. This has moderated the general rise for corporate borrowers.

Interestingly, although long-term nominal interest rates backed off modestly from their summer levels, the yield on 10-year Treasury inflation-indexed securities (TIIS) fell more substantially. Changes in the difference between the nominal Treasury bond yield and the 10-year TIIS provide some estimate of a change in inflation expectations. Since 1998, this differential has mostly hovered within a range of 1% to 2%, suggesting that expected long-term inflation rates were well anchored near recent levels. Limited experience with this series makes it difficult to assess any bias as an inflation indicator. Thus, the recent increase in the inferred inflation rate may not presage a jump in inflation as much as a diminished prospect of deflation.

The broad monetary aggregate M2 has declined since the summer but remains about 5% above its 2002:IVQ level. The slowdown in M2 growth on the year is welcomed by those who take it as an indicator of future inflation. Nevertheless, because M2 is a current indicator of economic activity, it is curious that M2 fell when real GDP surged. To some extent, the recent fall in M2 is attributable to the uptick in interest rates. Rising interest rates increase the opportunity cost of money and reduce the quantity demanded for a given level of economic activity. When mortgages are refinanced, funds used to pay off old mortgages typically go into an escrow account. These funds, included in M2, are then distributed (continued on next page)
Money and Financial Markets (cont.)

Once a month to holders of mortgage-backed securities. Thus, as mortgage refinancing activity has fallen, so have the funds held in escrow.

Mortgage refinancing has provided a large source of funds for consumers who have refinanced their homes at higher loan amounts and are using the cash for other spending. Some analysts have been concerned that consumption spending might tail off sharply if mortgage rates rise and the incentives for refinancing fall. On the positive side, consumer confidence has increased to pre-September 11 levels, although it remains below levels near the business cycle peak.

The key source of well-being in any economy is productivity growth, which enables standards of living to advance. Much of the interest in productivity gains has focused on their association with layoffs and falling employment. Over the longer term, however, higher productivity raises aggregate wealth. Ultimately, after some transition period, the rise in wealth is consistent with higher aggregate spending and therefore with new business investment and higher employment growth.

The recent surge in economic activity has been distributed largely among holders of capital in the form of sharply rising earnings. This trend is expected to continue in the form of expected future earnings growth, a key fundamental for stock prices. Because price/earnings ratios are well off their bubble period highs, higher earnings growth bodes well for stock valuations. Moreover, because so many households now hold equities in their 401(k) savings plans, the incremental increase in equity wealth should be distributed more broadly than it was in the past.

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b. Earnings after 2003:IIIQ are estimates provided by Standard and Poors.