Implied yields from eurodollar futures fell in August and September, suggesting that market participants expect the current round of tightening may end or moderate significantly in 2006. They may believe that after the rate hikes anticipated during the remainder of 2005, the federal funds rate will be more nearly consistent with a neutral policy.

During the current round of tightening, the real (inflation-adjusted) federal funds rate has increased more than 300 basis points (bp), consistent with the Federal Reserve’s intention of slowly removing monetary accommodation in order to avoid inflationary pressures.

Policymakers also must take into account the public’s outlook on inflation. One way to measure long-term inflation expectations is to look at the difference between the yield on a Treasury bond and the yield on a Treasury inflation-protected security (TIPS), keeping the maturity constant. The last two months have witnessed a small uptick in inflation expectations over a 10-year horizon. Such movements are not unusual and appear consistent with the FOMC’s statement that “longer-term inflation expectations remain contained.”

The yield curve continued to flatten during August and September, with the spread between 10-year Treasury bonds and one-year Treasury notes being only 34 bp. Such a small and declining spread may be caused by lower long-run inflationary expectations.

(continued on next page)
Short-term rates have moved in step with increases in the federal funds rate. Since the current round of policy tightening began, short-term Treasury rates have risen about 200 bp. However, long-term Treasury rates have fallen nearly 50 bp during the same period.

Long-term rates on conventional mortgages remain at historically low levels. Mortgage rates currently stand nearly half a percentage point lower than they were when the Fed began tightening policy in June 2004. In a recent speech, Chairman Alan Greenspan commented that “[t]his decline in mortgage rates and other long-term interest rates in the context of a concurrent rise in the federal funds rate is without precedent in recent U.S. experience.”

He attributed the decline in long-term rates to a number of factors, including lower inflation expectations, lower risk premiums arising from reduced inflation volatility, lower term premiums resulting from less variability in real economic activity, and higher worldwide saving. Recent estimates by the Federal Reserve Board suggest that much of the recent decline in long rates has been caused by a fall in term premiums.

Risk spreads on corporate debt remain near historically low levels. Although risk spreads on high-yield bonds rose more than 160 bp from the beginning of the year until mid-May, they have since taken back more than half that increase. Low risk spreads may indicate investors’ greater willingness to take on risk.

Since 2002:IIIQ, the household wealth-to-income ratio has trended
upward. Rising stock market prices contributed to this trend in its early stages. Even though stock prices have changed little so far this year, the upward trend in the wealth-to-income ratio continues, primarily because of rising home prices. Increases in the wealth-to-income have helped support consumer spending. After averaging 4.9% over the last 20 years, the personal saving rate currently is 0.3% of disposable income. Higher levels of wealth enable households to feel more comfortable with a lower saving rate.

Household debt rose at an annual rate of over 9.5% during the first half of the year, fueled strongly by an increase in mortgage debt. Nonetheless, mortgage debt growth during the first half of the year was attenuated compared to its brisk growth during 2004. Growth in consumer credit remained less robust because households turned to home equity to finance expenditures. Despite the increases in household debt, delinquency rates on consumer loans remain low.

The University of Michigan’s Consumer Sentiment Index plummeted in September. The decline, greater than anticipated, was the largest drop since December 1980. Analysts attributed the steep decline in confidence to soaring energy prices and the impact of Hurricane Katrina. The Conference Board’s Index of Consumer Confidence took a similar hit in September and likewise posted its largest drop in 25 years. Consumer confidence weakened in all components of the index. Analysts expect consumer confidence to rebound as recent declines in wholesale energy prices feed through to consumers.