COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D.C. 20500

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August 31, 1984

MEMORANDUM TO CCEA

FROM: William Poole W.P.

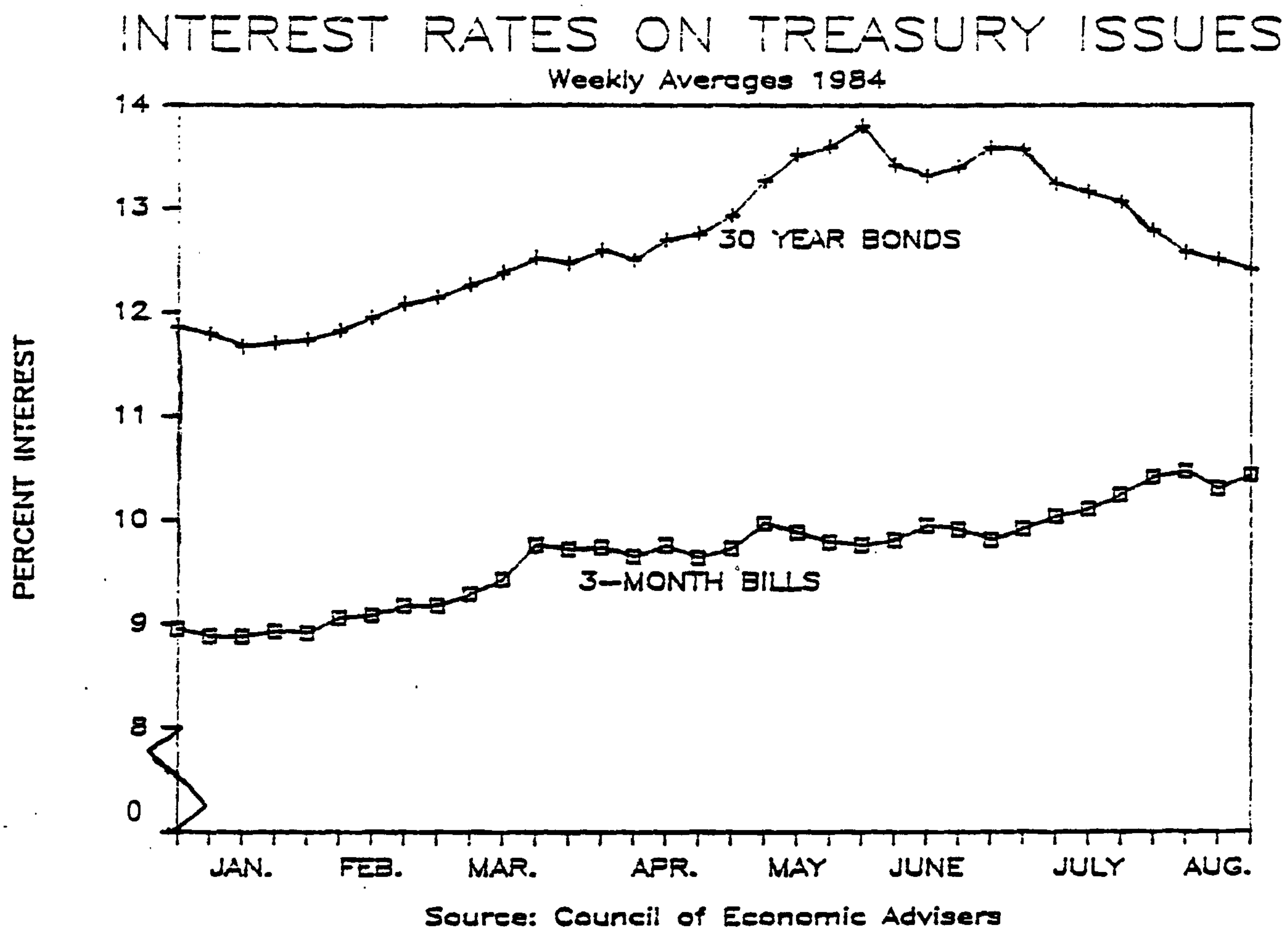
SUBJECT: Financial Markets Update

Since our last financial markets update on June 21 the big news in the credit markets is that there isn't much news. Much of the bond market nervousness apparent in the spring has disappeared. The stock market surged dramatically in early August, but otherwise has been fairly stable. These developments reflect an underlying economic environment that the the markets perceive to be relatively stable.

Interest Rates

The chart below shows the weekly average 3-month Treasury bill rate and 30-year Treasury bond yield from January through August of this year. The bill rate rose by about 80 basis points from early January to late May and by another 70 basis points to late August. In contrast, the bond yield rose by 200 basis points from January to late May -- an unusually large increase relative to the magnitude of the bill rate increase. Since late May a more normal bill-bond yield relationship has been restored as the bond yield declined by about 140 basis points from late May to late August. The net change from early January to late August is that bills are up by about 150 basis points and bonds by about 55 basis points.

The increase in the bill rate since late May overstates the upward pressure on the short end of the market. The Continental Illinois Bank problems produced a minor "flight to quality" that held the bill rate down in May. As the markets have steadied that phenomenon has largely disappeared. By late August the rates on CDs and commercial paper were at or below their levels in early July. The prime rate, at 13.00 percent, hasn't changed since late June.

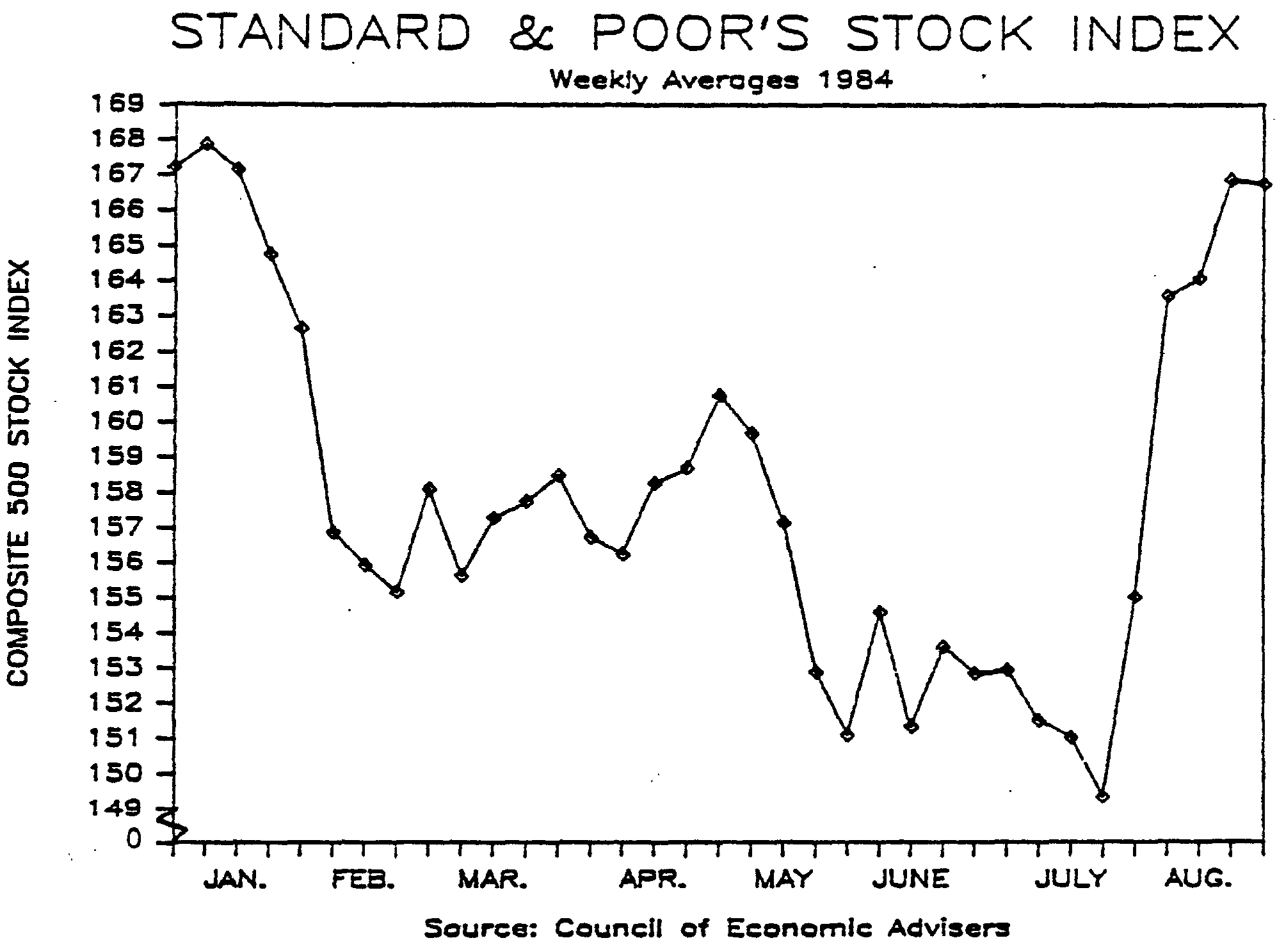


Taking the January-August period as a whole, the flattening of the yield curve is a sign that market appraisals of the future are becoming more stable. As noted, from January to August the increase in the bond yield was about one-third the increase in the bill yield. In contrast, over the same months of 1983 the bond yield rose by 166 basis points while the bill rate was rising by 148 basis points. Experience this year is a return toward the historical norm and away from the almost one for one yield changes in the short and long markets that characterized most of the period from 1979 to 1983.

Yields on fixed rate home mortgages have been rising most of the year, reflecting the usual lag behind long-term bond yields. However, with bond yields declining significantly starting in early July, mortgage rates first leveled off in July and then declined in August.

Stock Prices

From January through late July stock prices fluctuated irregularly downward. The first three days of August saw an explosive rise in stock prices on extremely heavy volume. Some further gains occured over the rest of August, taking broad stock price indexes back to their January levels.



Forces Operating on the Markets

Neither the timing nor the magnitude of the early August surge in the stock maket can be explained. But, in general, both the bond and stock markets seem to be responding to the following economic forces:

- o Economic data indicating a slower pace of expansion reduce fears that higher credit will push interest rates up. Such news also reduces concerns that the Federal Reserve will tighten monetary policy by pushing rates up.

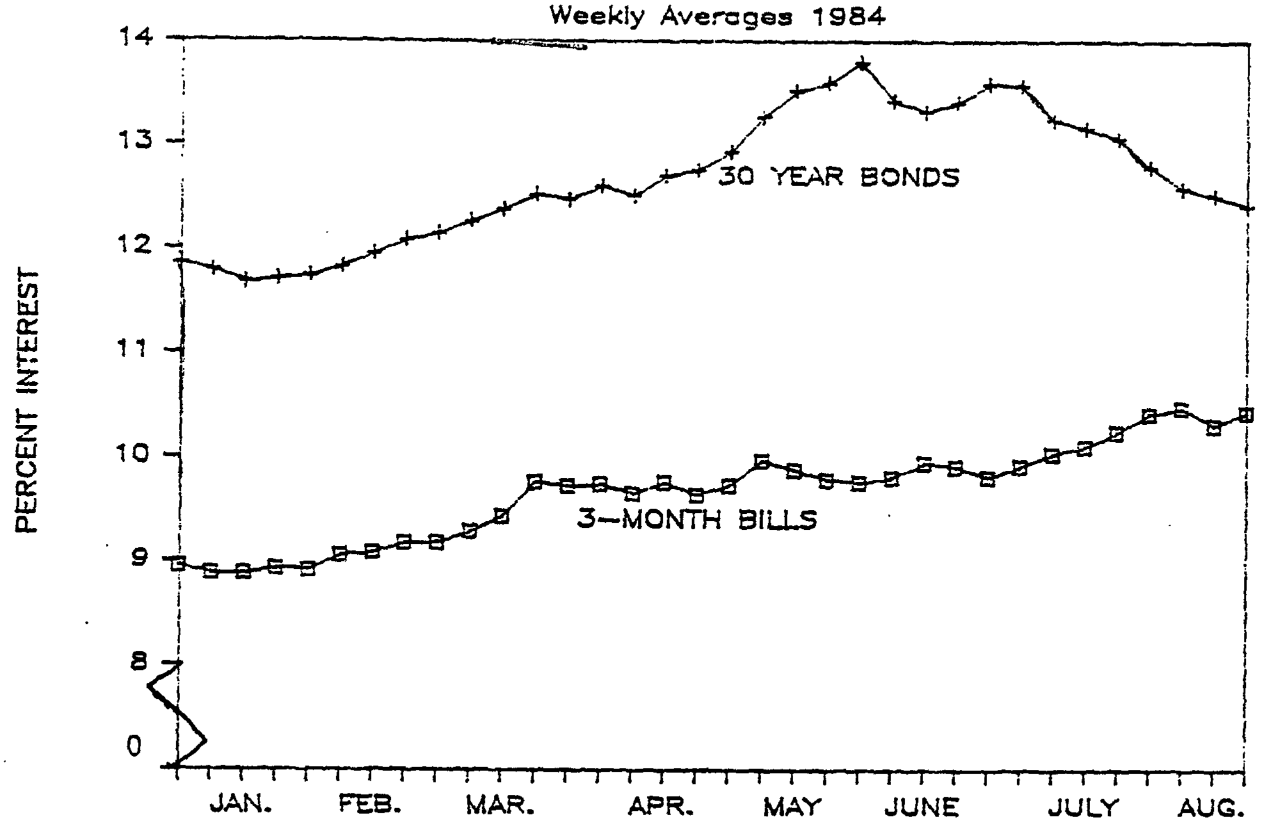
- Slower money growth suggests that the Federal Reserve has no compelling reason to push interest rates up.

- Federal Reserve statements are examined closely for clues as to the Fed's analysis of the economic situation and the Fed's policy intentions. In July the Fed's mid-year economic report was greeted positively because it seemed to promise no immediate tightening of monetary policy. Conversely, the FOMC's July Policy Record released in late August produced a minor upward blip in interest rates because it seemed to lower the odds that monetary poicy might be eased in coming months.

The net effect of the stream of economic data releases, statements by public officials, and moderating growth in credit demands has been to produce the market behavior outlined earlier in this memorandum. As noted above, the only noteworthy features of the recent course of interest rates are the greater stability in the credit markets and the substantial reversal of the run-up in bond yields that occurred between January and late May.

INTEREST RATES ON TREASURY ISSUES

Weekly Averages 1984



Source: Council of Economic Advisers

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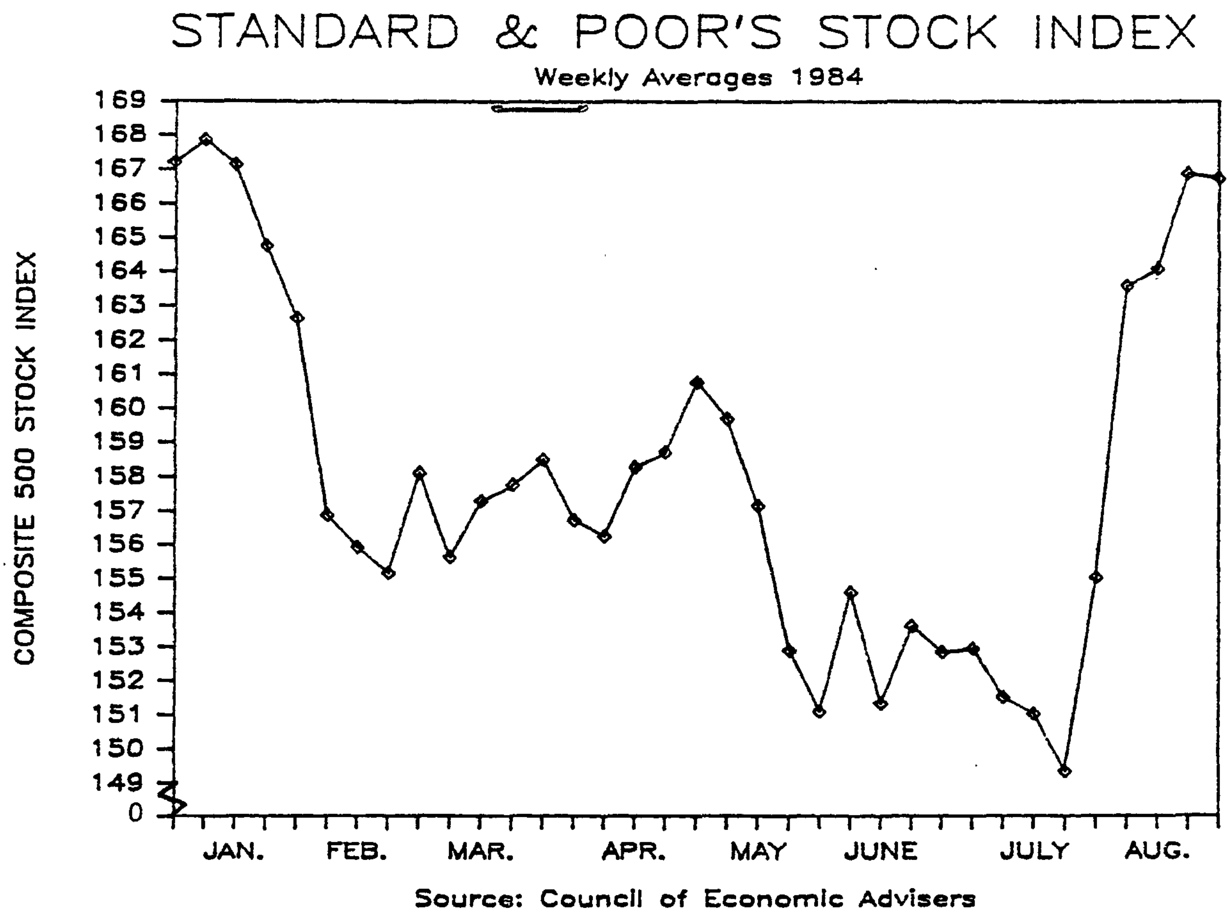

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