The Money and Bond Markets in July

The nation's financial system demonstrated great resiliency during July by withstanding its most strenuous trial in years. Confidence in the commercial paper market was severely tested in the wake of the filing on June 21 of a petition for reorganization by the Penn Central Company covering its railroad subsidiary. The prompt response of the Board of Governors of the Federal Reserve System in suspending Regulation Q ceilings on large short-term time deposits, effective June 24, helped to prevent the emergency from snowballing into a cumulative spiral of business failures. The Board's action promoted a rechanneling of credit through the banking system. Banks were able to obtain funds through sales of negotiable certificates of deposit (CD's), thereby facilitating lending to firms having difficulty rolling over maturing commercial paper. Banks also obtained liberal accommodation at the Reserve Banks' discount window. The Federal Reserve System thus fulfilled its historic role as lender of last resort.

The severe pressures affecting the commercial paper market did not spread to other securities markets. Although some uneasiness was evident, rates generally declined. The Federal funds rate moved slightly lower in July, as did Treasury bill rates despite the Treasury's auction of \$4¾ billion of tax anticipation bills (TAB's). The capital markets were buoyant and yields on United States Government, municipal, and high-grade corporate bonds declined substantially over the month. Yields on lower rated corporate issues remained at record levels, however, reflecting a shift in investor preference toward minimization of credit risk. Market sentiment was encouraged by an apparent improvement in the prospects for peace in the Middle and Far East and by indications that the slowdown in the economy was bottoming out. There was also a growing belief that securities yields had seen their peaks for the current cycle.

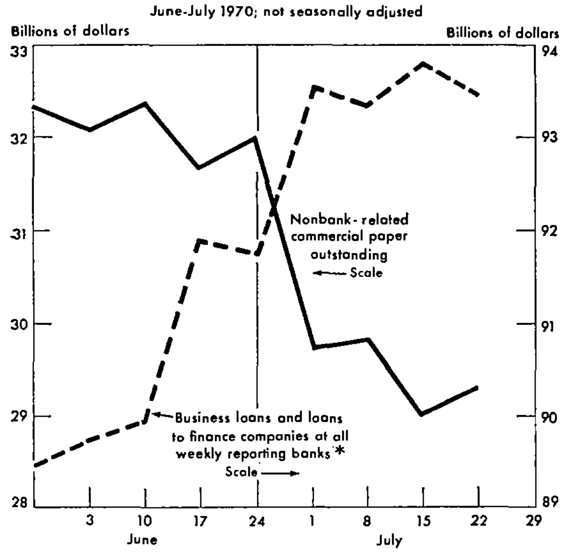
BANK RESERVES AND THE MONEY MARKET

The commercial banking system met a rapidly expanding demand for short-term credit in July (see Chart I), when many borrowers were unable to obtain adequate financing in the commercial paper market. The value of outstanding commercial paper (not seasonally adjusted) issued by institutions other than banks dropped by \$2¾ billion in the four weeks ended on July 22, reflecting the new emphasis placed by investors on higher quality assets. This shift in investor preference forced borrowers of lesser standing to approach commercial banks for loans or, in some instances, to sell receivables. Banks were able to meet the higher credit demand through additional deposits made possible by the partial suspension on June 24 of Regulation Q ceilings and through increased reserves supplied by the System. CD's at weekly reporting banks increased by \$3.9 billion during the four weeks ended on July 22. In the same four-week period, member bank

Chart I

COMMERCIAL PAPER AND BUSINESS LOANS

June-July 1970; not seasonally adjusted



* Including business loans sold to affiliates.

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, JULY 1970

In millions of dollars; (+) denotes increase (—) decrease in excess reserves

Factors	Changes in daily averages—week ended on July 1	July 8	July 15	July 22	July 29	Net changes
"Market" factors						
Member bank required reserves	— 360	— 222	— 259	— 164	+ 134	— 871
Operating transactions (subtotal)	— 93	— 64	— 680	+ 328	+ 157	— 352
Federal Reserve float	— 544	+ 574	— 524	+ 480	— 681	— 695
Treasury operations*	+ 99	— 179	+ 109	+ 145	— 25	+ 149
Gold and foreign account	+ 44	— 23	— 39	+ 44	+ 8	+ 34
Currency outside banks	+ 360	— 365	— 315	— 448	+910	+ 142
Other Federal Reserve liabilities and capital	— 53	— 70	+ 88	+ 106	— 55	+ 16
Total "market" factors	— 453	— 286	— 939	+ 164	+ 291	—1,223
Direct Federal Reserve credit transactions						
Open market operations (subtotal)	+ 440	— 72	+ 794	+ 110	— 305	+ 967
Outright holdings:						
Government securities	+ 445	— 73	—	+ 638	— 42	+ 968
Bankers' acceptances	— 5	+ 1	—	— 1	+ 4	— 1
Repurchase agreements:						
Government securities	—	—	+ 632	— 444	— 188	—
Bankers' acceptances	—	—	+ 63	— 22	— 41	—
Federal agency obligations	—	—	+ 99	— 61	— 38	—
Member bank borrowings	+ 106	+ 303	+ 384	— 293	— 156	+ 344
Other Federal Reserve assets†	+ 97	— 143	— 128	—	+ 7	— 167
Total	+ 643	+ 88	+1,050	— 183	— 456	+1,142
Excess reserves	+ 190	— 198	+ 111	— 18	— 167	— 82

Member bank:	Daily average levels					Monthly averages
Total reserves, including vault cash	27,823	27,847	28,217	28,362	28,063	28,062‡
Required reserves	27,550	27,772	28,031	28,195	28,061	27,922‡
Excess reserves	273	75	186	168	1	141‡
Borrowings	991	1,294	1,680	1,387	1,231	1,317‡
Free, or net borrowed (—), reserves	— 718	—1,219	—1,494	—1,219	—1,230	—1,176‡
Nonborrowed reserves	26,832	26,553	26,537	26,975	26,832	26,746‡
Net carry-over, excess or deficit (—)§	78	158	53	119	130	108‡

System Account holdings of Government securities maturing in:	Changes in Wednesday levels					Net changes
Less than one year	+ 709	— 43	+1,168	— 701	+ 200	+1,333
More than one year	—	—	—	—	—	—
Total	+ 709	— 43	+1,168	— 701	+ 200	+1,333

Note: Because of rounding, figures do not necessarily add to totals.
*Includes changes in Treasury currency and cash.
† Includes assets denominated in foreign currencies.
‡ Average for five weeks ended on July 29.
§ Not reflected in data above.

Table II

RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS JULY 1970

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended on July 1	July 8	July 15	July 22	July 29	Averages of five weeks ended on July 29
Eight banks in New York City						
Reserve excess or deficiency (—)*	46	— 44	39	38	3	16
Less borrowings from Reserve Banks	93	360	468	139	29	218
Less net interbank Federal funds purchases or sales (—)	1,012	1,821	1,709	1,087	831	1,292
Gross purchases	2,339	2,699	2,689	2,221	2,135	2,417
Gross sales	1,327	878	980	1,134	1,304	1,125
Equals net basic reserve surplus or deficit (—)	—1,059	—2,223	—2,138	—1,188	— 857	—1,493
Net loans to Government securities dealers	473	661	345	563	984	605
Net carry-over, excess or deficit (—)†	6	32	— 9	31	44	21
Thirty-eight hanks outside New York City						
Reserve excess or deficiency (—)*	— 131	— 47	15	39	— 76	— 40
Less borrowings from Reserve Banks	260	412	571	531	528	460
Less net interbank Federal funds purchases or sales (—)	2,745	2,874	3,827	3,701	3,479	3,325
Gross purchases	4,963	5,299	5,760	5,583	6,138	5,349
Gross sales	2,218	2,425	1,933	1,882	1,659	2,023
Equals net basic reserve surplus or deficit (—)	—3,136	—3,333	—4,383	—4,193	—4,083	—3,826
Net loans to Government securities dealers	126	245	151	304	852	336
Net carry-over, excess or deficit (—)†	16	36	4	21	25	20

Note: Because of rounding, figures do not necessarily add to totals.
* Reserves held after all adjustments applicable to the reporting period less required reserves.
† Not reflected in data above.

Table III

AVERAGE ISSUING RATES* AT REGULAR TREASURY BILL AUCTIONS

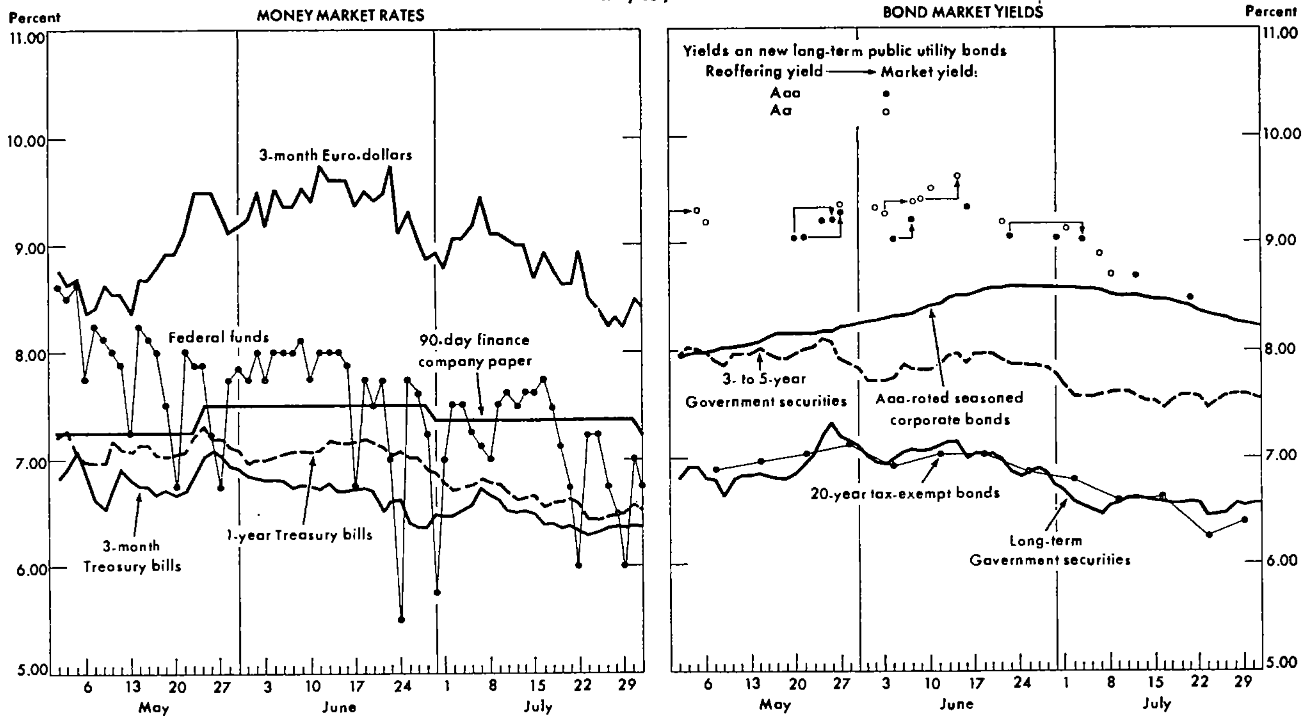
In percent

Maturities	Weekly auction dates—July 1970: July 6	July 13	July 20	July 27
Three-month	6.642	6.547	6.385	6.345
Six-month	6.656	6.644	6.442	6.429

Maturities	Monthly auction dates—May-July 1970: May 26	June 23	July 23
Nine-month	7.352	7.069	6.467
One-year	7.277	7.079	6.379

* Interest rates on bills are quoted in terms of a 360-day year, with the discounts from par as the return on the face amount of the bills payable at maturity. Bond yield equivalents, related to the amount actually invested, would be slightly higher.

Chart II
SELECTED INTEREST RATES
May-July 1970



Note: Data are shown for business days only.

MONEY MARKET RATES QUOTED: Bid rates for three-month Euro-dollars in London; offering rates for directly placed finance company paper; the effective rate on Federal funds (the rate most representative of the transactions executed); closing bid rates (quoted in terms of rate of discount) on newest outstanding three-month and one-year Treasury bills.

BOND MARKET YIELDS QUOTED: Yields on new Aaa- and Aa-rated public utility bonds (arrows point from underwriting syndicate reoffering yield on a given issue to market yield on the same issue immediately after it has been released from syndicate restrictions); daily averages of yields on seasoned Aaa-rated corporate bonds; daily averages of yields on long-term Government securities (bonds due or callable in ten years or more) and on Government securities due in three to five years, computed on the basis of closing bid prices; Thursday averages of yields on twenty seasoned twenty-year tax-exempt bonds (carrying Moody's ratings of Aaa, Aa, A, and Baa).

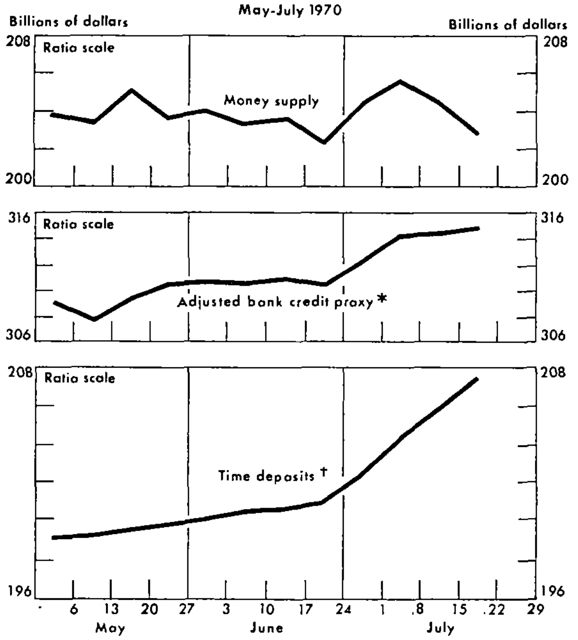
Sources: Federal Reserve Bank of New York, Board of Governors of the Federal Reserve System, Moody's Investors Service, and The Weekly Bond Buyer.

borrowings from the System rose almost \$½ billion (see Table I) over the average of the previous four weeks in June. The basic reserve position of the forty-six major reserve city banks averaged \$5.3 billion in the five weeks ended on July 29 (see Table II).

The Federal funds rate hovered around 7½ percent for most of July before moving somewhat lower at the end of the month (see Chart II). Euro-dollar rates remained at the lower levels established in late June, as United States banks further reduced their Euro-dollar borrowings.

The impact of recent financial developments is clearly evident in the growth of time deposits in July. The upsurge in CD's after the partial suspension of Regulation Q led to a jump in time deposits (see Chart III). Daily average time deposits at all commercial banks expanded at a 40½ percent seasonally adjusted annual rate during the four weeks ended on July 22, compared with the average of the previous month. The July advance followed a 7¾ percent annual rate of increase in June. Similarly, the adjusted bank credit proxy, which includes time deposits as well as all other member bank deposits and nondeposit liabilities, showed substantial growth in July, rising at a 17½ percent annual rate during the four-week period ended on July 22. In June, the bank credit proxy had increased at a 7 percent rate. The seasonally adjusted average money supply rose during the same four weeks in July at an annual rate of 5¾ percent after declining at a 1¾ percent annual rate in June.

Chart III
CREDIT AND MONETARY AGGREGATES
Seasonally adjusted weekly averages
May-July 1970



Note: Data for July are preliminary.
* Total member bank deposits subject to reserve requirements plus nondeposit liabilities, including Euro-dollar borrowings and commercial paper issued by bank holding companies or other affiliates.
† At all commercial banks.

THE GOVERNMENT SECURITIES MARKET

The downward movement in yields on United States Government securities continued during July in response to optimistic reports on both the domestic and international fronts. Developments in the shorter term area of the market were punctuated by two auctions of TAB's on July 2 and July 16. Activity in the longer term sector was quiet and overshadowed, particularly later in the month, by participants' anticipation of the upcoming August refunding.

The market for United States Government notes and bonds remained firm in July. During the first days of the month, yields on long- and intermediate-term Treasury securities showed substantial declines in continuation of the rally that began late in June. Subsequently, however, yields on most issues fluctuated in quiet trading that reflected some profit taking and a movement by investors into corporate securities. Activity increased in the third calendar week of July, after improved prospects for a Middle East truce stimulated investor demand. However, yields showed little change during this and the final week of the month, as the market awaited details of the Treasury's August refunding.

The Treasury bill market continued to receive an inflow of funds from other financial markets, as investors placed increased emphasis on the quality of their investment holdings. Treasury bill rates moved somewhat higher during the first full business week in July, when dealers reduced their positions in bills prior to receipt of the newly auctioned TAB's. Conditions improved in the second week of the month, however, with Federal Reserve purchases and increased foreign demand for bills contributing to the better atmosphere. In the third week, modest but steady investor demand continued to lower rates on most bills, but this tendency diminished toward the end of the month. Over the month as a whole, rates on bills due within three months were generally 8 to 30 basis points higher while rates on longer term bills were from 1 to 40 points lower. The average issuing rates on new Treasury bills set at the weekly and monthly auctions declined (see Table III). The March 1971 TAB's auctioned on July 2 were issued at an average rate of 6.452 percent, while the April 1971 TAB's auctioned two weeks later yielded 6.504 percent.

On July 29 the Treasury announced the terms of its August refunding. The Treasury offered holders of the \$6.5 billion of 6⅜ percent notes and 4 percent bonds maturing August 15 the option of exchanging their holdings for a 7¾ percent 3½-year note, priced at par, or a 7¾ percent seven-year note which will be discounted to yield about 7.80 percent. In addition, the Treasury announced it will offer for cash approximately \$2¾ billion of a 7½ percent eighteen-month note which will be priced to yield about 7.54 percent. Payments for this note would cover the unexchanged portion of the August 15 maturities and raise some new cash. Qualified depositories will be permitted to make payment for the eighteen-month note by crediting up to 50 percent of their purchases to their Treasury Tax and Loan Accounts. The subscription period for the 3½- and seven-year notes will run from August 3 through August 5, while subscriptions for the eighteen-month note will be accepted only on August 5.

OTHER SECURITIES MARKETS

The corporate and municipal securities markets rebounded strongly in July, and yields fell to their lowest levels since March. Some uneasiness, however, was apparent in the shift of investor preference away from less highly rated offerings. Issuing rates on lower rated securities remained at very high levels over the month, prompting some postponements of previously planned new financings.

The resurgence of demand for corporate securities that developed during the second half of June continued into the first week of July amid light new issue activity. The rally culminated in substantial declines in yields on July 7 and 8, but some profit taking and a buildup of the schedule of new offerings later caused yields to fluctuate until mid-month. Subsequently, yields resumed their declines until late in the month, when heavier new issue activity and uncertainty over the terms and market effect of the Treasury's refunding briefly caused yields to rise. The downward trend in yields since mid-June was underscored by an offering on July 21 of $100 million of Aaa-rated telephone company bonds. The bonds, which were due in thirty-six years and carried five years of call protection, were offered at a yield of 8.50 percent, or 55 basis points below a similar offering on June 30 and 85 basis points below another top-rated telephone company flotation marketed on June 16. Although not all the bonds were placed with investors at that price, a World Bank issue consisting of $200 million of Aaa-rated 25-year bonds was offered two days later at 8.625 percent and met an excellent reception.

Yields on most outstanding and new tax-exempt issues declined decisively during most of July. New issue activity was heavier than usual, as declining yields allowed some issuers, who were unable to float new securities earlier because of interest rate ceilings, to return to the market. A boost was given to the tax-exempt market on July 22, when a long-anticipated Internal Revenue Service ruling indicated that interest costs incurred by banks in the ordinary course of business would be deductible for tax purposes unless there were circumstances demonstrating a direct connection between these borrowings and tax-exempt investments. Prior to this ruling, there was considerable controversy over whether banks would be allowed to deduct costs of acquiring funds which were then used in part to obtain tax-exempt securities. Over the month as a whole, yields were sharply lower and *The Weekly Bond Buyer's* index of seasoned tax-exempt bonds declined 46 basis points, the largest such decline since February of this year.