

# Interest Rates

## Sightlines Bulletin August 2014 Report

### **Fed Continues to Reduce Asset Purchases**

The FOMC last met on July 29 and 30. The Fed continued on the path toward ending asset purchases by the end of 2014. The monthly purchases of mortgage backed securities were reduced to \$10 billion and for treasury securities to \$15 billion. There are three remaining meetings of the FOMC during 2014. It is anticipated the end of the asset purchase program will be announced at the October 28 – 29 meeting.

The strong rebound of the nation's economy during the second quarter and positive subsequent data releases related to job openings and industrial output could accelerate the schedule for Fed action on interest rates. However, Chair Yellen has at least so far shown an inclination to maintain low interest rates as long as labor markets and income growth remain weak and inflation remains below the Fed's 2 percent target.

The FOMC meets next on September 16 and 17. Updated economic forecasts will be presented at this meeting.

### **Fed Asset Purchases Slow and Federal Deficit Drops**

As of August 6, the Fed held \$4.097 trillion in Treasury and mortgage-backed securities – Treasury holdings of \$2.423 trillion and mortgage-backed holdings of \$1.674 trillion. Prior to the first round of quantitative easing, which began during November 2008, the Fed held only \$476.5 billion in Treasury debt on its balance sheet and no mortgage-backed debt. Fed policy-makers indicate that reductions in asset holdings will occur very slowly so as not to adversely impact interest rates.

As of June, the total amount of U.S. public debt outstanding equaled \$17.687 trillion. Of the total \$12.163 trillion was marketable debt and \$5.524 trillion was nonmarketable. Thus, the Fed holds about 19.9 percent of total marketable U.S. Treasury debt.

The U.S. Government's deficit continues to shrink. At the end of July the FY 2014 deficit equaled \$460.5 billion. Last year at the same time the deficit equaled \$607.4 billion. This \$147.0 billion (24.2%) decline is attributable to \$182.0 billion in higher receipts and only a \$35.0 billion increase in outlays. Currently, the official budget forecast for FY 2014 equals a deficit of \$583.0 billion. However, if current revenue and outlay trends continue the actual deficit will likely drop to about \$500 billion, or 2.9% of GDP.

### **Inflation Remains under Control, except for Energy Prices**

During June the consumer price index (CPI) jumped by 3.09% annualized, which makes for three months in a row of over 3 percent increases. The consumer price index excluding food and energy (Core CPI) also increased, but by only 1.55% annualized. Energy prices jumped at a 19.25% annualized rate.

On a year-over-year basis the CPI increased by 2.08% and the Core CPI increased by 1.93% during June.

CPI statistics for July will not be released until August 19<sup>th</sup>.

### **Short Maturity Yields Up Slightly/ Long Maturity Yields Drop Below Year Ago Levels**

During July the average 1-year yield equaled 0.11% up one basis point from June and the average 2-year yield increased from 0.45% to 0.51%. The average 3-year yield increased from 0.90% to 0.97% and the average 5-year yield rose from 1.68% to 1.70%. A year earlier the 1-year, 2-year, 3-year, and 5-year yields equaled 0.12%, 0.34%, 0.64%, and 1.40%, respectively.

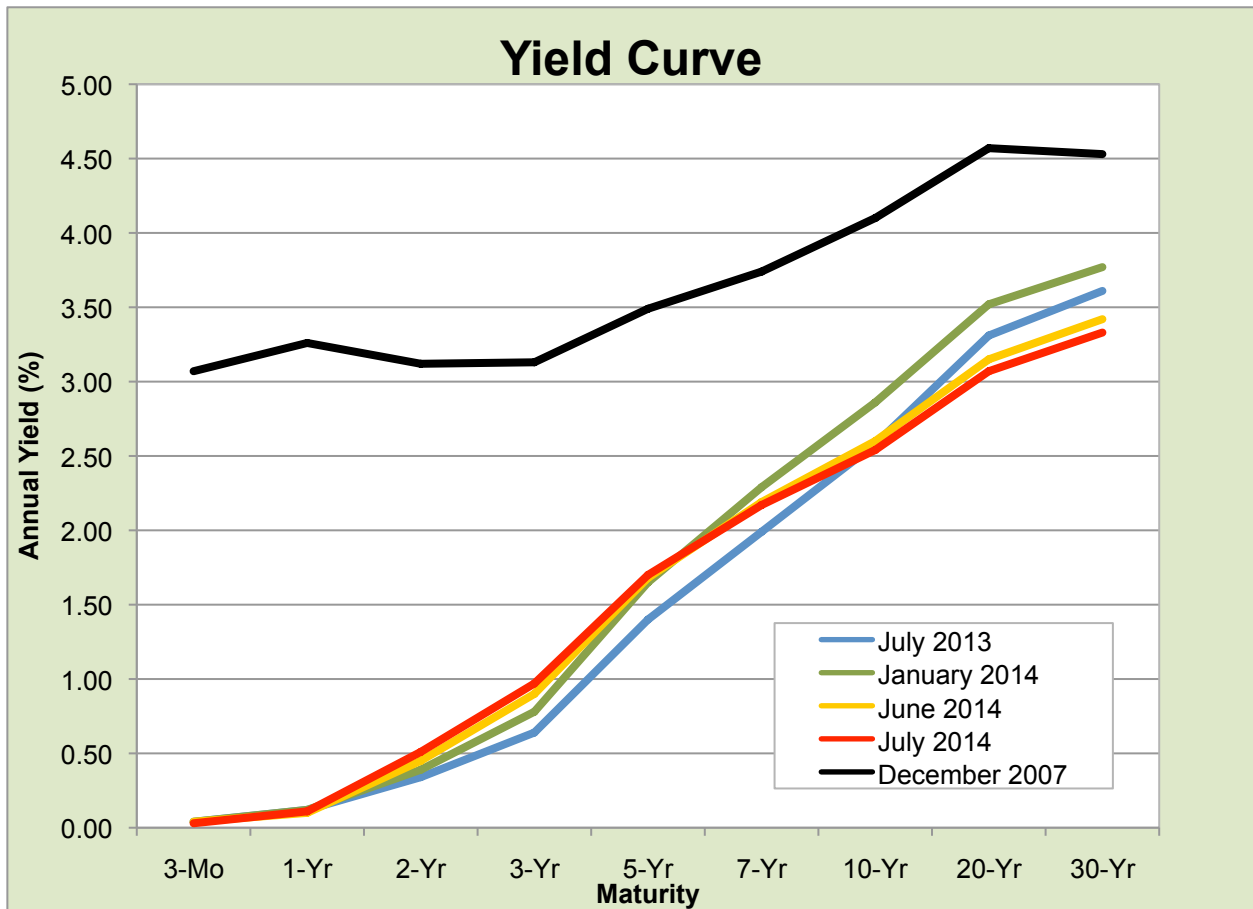
The average yield on the 7-year note decreased by 2 basis points from 2.19% to 2.17%. For the 10-year note the average yield decreased 6 basis points from 2.60% to 2.54%. One year ago these average yields equaled 1.99% and 2.58%.

The 20-year bond yield decreased from 3.15% to 3.07% and 30-year bond yield decreased from 3.42% to 3.33%. During July 2013 the yields for these two maturities averaged 3.31% and 3.61%, respectively. Thus, the yields for Treasuries with maturities of 10 years and longer are now below their year ago levels.

### **Yield Curve Continues to Flatten as Long Maturity Yields Decrease**

The following chart shows that the yields for the longest maturities (10-, 20- and 30-year) have moved below where they were a year ago. This retreat on the yields for the longer maturities has continued a trend that began in January. It is interesting that this reduction in long yields occurred over the period when the Federal Reserve reduced mortgage-backed security and treasury asset purchases from \$85 billion per month to \$35 billion per month.

On the other hand, average yields for the 1-year to 5-year maturities again rose slightly. Over the past year the increases have been greatest for the 3-year to 5-year notes. One reason the yields on the mid-term maturities have increased is because these are the maturities where the Treasury has concentrated its debt issuance activity. From January through July the amount of net new Treasury debt equals \$276.3 billion. Treasury notes (1- to 10-year maturities) have accounted for \$345.2 billion (124.9%) of net new debt issues and the share accounted for by bonds (20- and 30-year maturities) equals \$113.0 billion (40.9%), while the share accounted for by Treasury bills (maturities under 1-year) has decreased by \$182.0 billion (-65.9%).

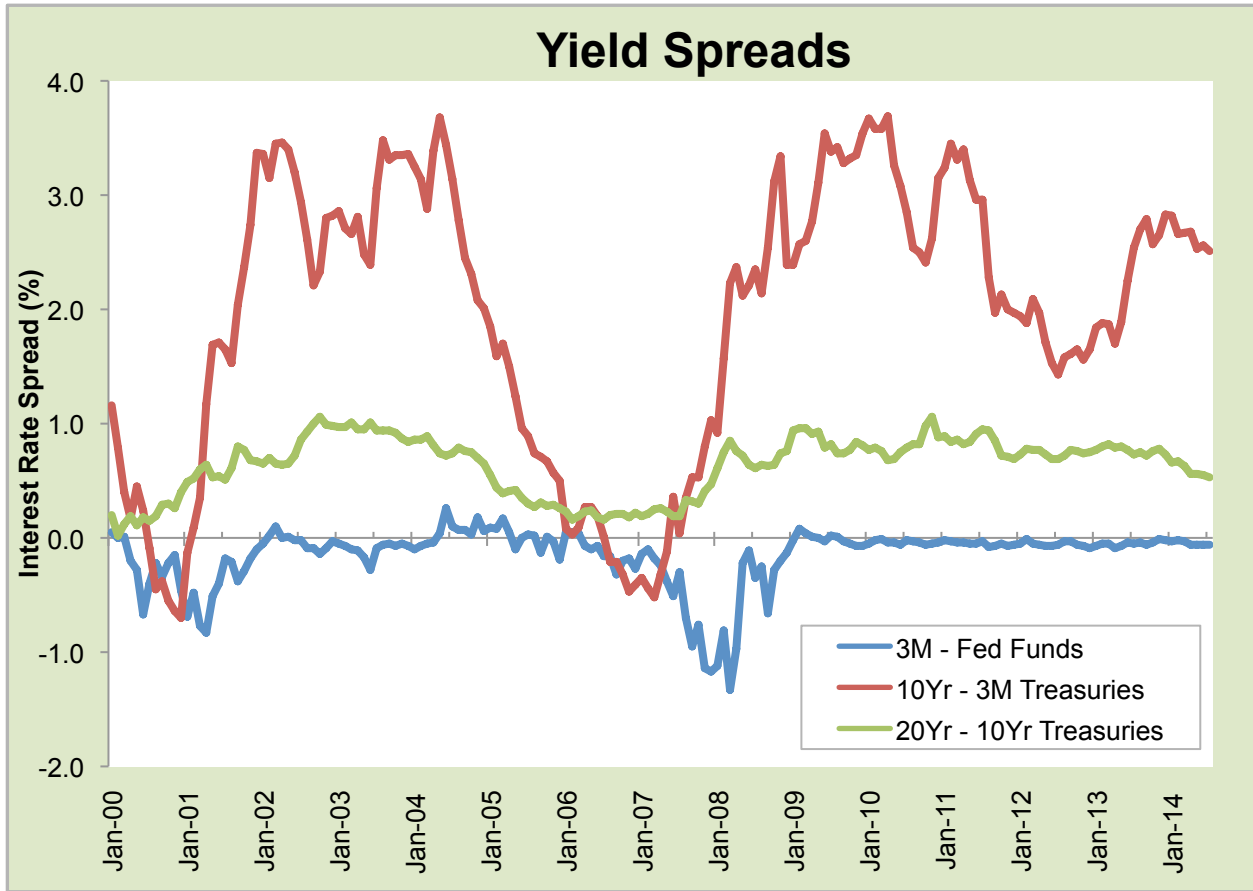


#### Treasury Security Interest Rate Spreads Imply Continued Strengthening of the Economy

The spread between the 3-month Treasury bill and the effective Federal Funds rate remained in negative territory during June and remained unchanged at -0.06%. The spread has not been positive since September 2009. Also, the target Federal Funds rate has not been changed since that time.

The yield spread between 20-year and 10-year Treasury securities decreased by 2 basis points to 0.53%. Over the past year this spread has decreased by 20 basis points. This change can be attributed to a 4 basis point decrease in the 10-year yield and a 24 basis point decrease in the 20-year yield.

The spread between interest rates for 10-year and 3-month Treasuries decreased by 5 basis points from 2.56% to 2.51%. This spread remains at a fairly high level but off its 12-month high which was 2.83% last December. All of the recent decrease in this spread can be attributed to a drop in the yield for 10-year notes. Often when this spread decreases it indicates a slowing of the economy, but in those cases almost all of the contraction results from increases in the 3-month yield rather than drops in the 10-year yield.



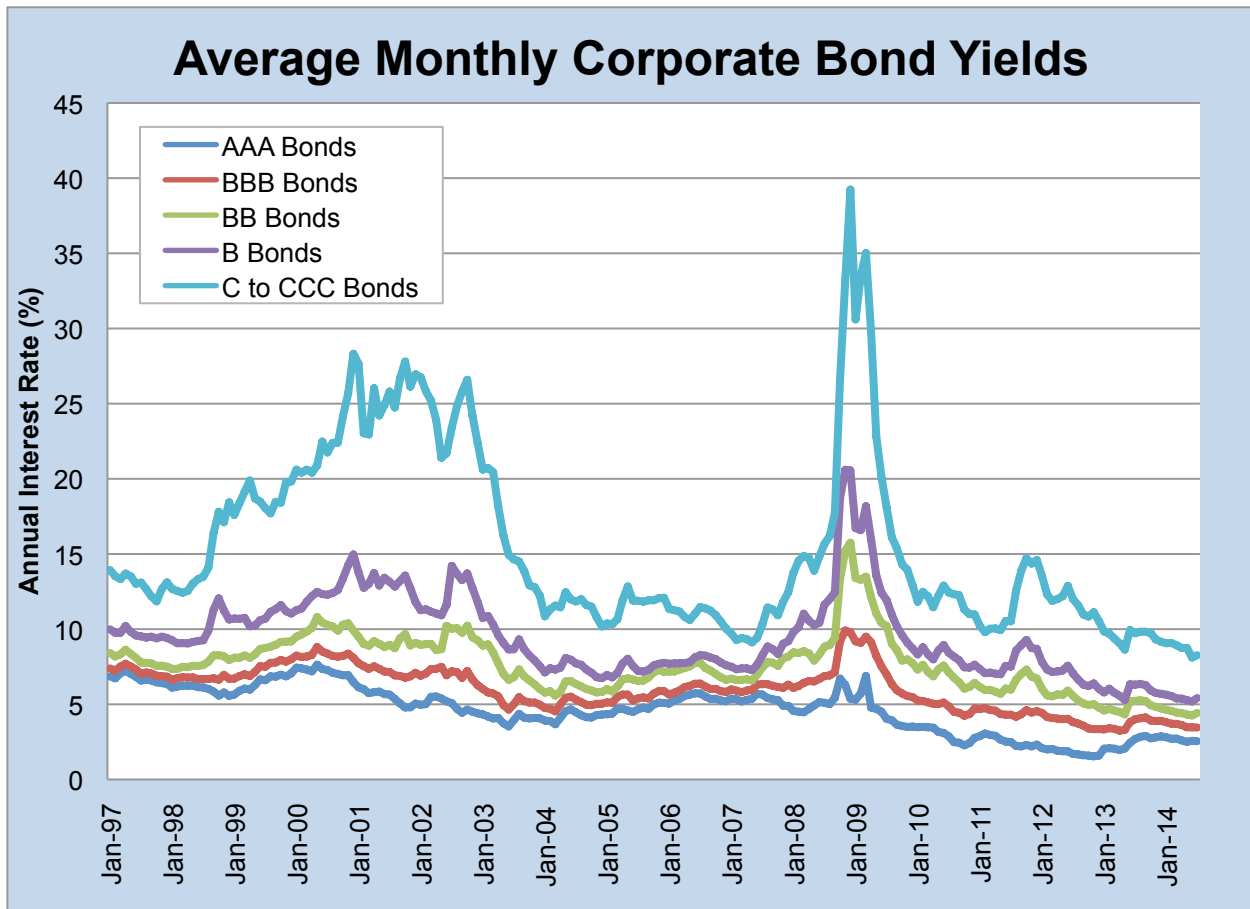
**Corporate Debt Investment Grade Yields Decrease/ High Risk Debt Yields Increase**

During July the average yield on AAA corporate bonds decreased from 2.57% to 2.55%. For BBB rated corporate bonds the average yield decreased one basis point from 3.47% to 3.46%. During July 2013 the average yields for AAA and BBB-rated bonds equaled 2.70% and 4.01%, respectively.

The average yields for BB-rated and B-rated bonds experienced large increases. For BB-rated bonds the yield increased from 4.26% to 4.43%. The average yield for B-rated bonds increased from 5.19% to 5.42%. The average yield for CCC and lower rated bonds increased by 16 basis points from 8.11% to 8.27%. During July 2013 the average yields for BB and B-rated corporate bonds equaled 5.23% and 6.31%, respectively. For CCC and lower rated bonds the July 2013 average yield equaled 9.73%.

The amount of corporate debt issued during July equaled only \$89.2 billion. This is the lowest amount of new debt since last December. From January through June the average monthly issuance of new corporate debt equaled \$138 billion. Of the July total, \$25.9 billion (29.0%) was classified as high yield. During July 2013 new corporate debt issues equaled \$96.9 billion, which included \$20.1 billion classified as high yield. So far this year \$917.0 billion in new corporate debt has been issued. This compares to \$828.6 billion during the same period last year.

Corporate bond yield trends are shown in the following chart.



#### Mortgage Interest Rates Move Slightly Lower

During July the average interest rate for 30-year conventional fixed rate mortgages decreased from 4.16% to 4.13%. This is the lowest the 30-year rate has been in a year. Last July the rate equaled 4.37%. So after moving to as high as 4.49% in September 2013, the 30-year mortgage rate is now below where it was last year.

For 15-year conventional fixed rate mortgages the average interest rate dropped to 3.24% in July from 3.27% in June. A year earlier this interest rate equaled 3.43%.

The National Association of Realtors reported in its July 22<sup>nd</sup> press release that existing home sales increased by 2.6% in June to a 5.04 million units seasonally adjusted annual rate (SAAR) from May's revised 4.91 million units SAAR. However, this is below the 5.16 million units SAAR a year ago. Also, the press release notes that "Inventories are at their highest level in a year and price gains have slowed." Both of these factors, along with lower mortgage interest rates, favor increased home sales in coming months. Data on July existing home sales will be released on August 21<sup>st</sup>.

During June, the number of single-family residential building permits issued equaled 631,000 SAAR compared to 615,000 SAAR during May and to 627,000 SAAR during June 2013. The number of single-family housing starts during June equaled 575,000 SAAR down sharply from the 632,000 SAAR during

May. A year earlier the number of single-family housing starts equaled 601,000 SAAR during June. July housing permits and starts data will be released on August 19<sup>th</sup>.

