The Federal Reserve Board

Meeting of the Federal Open Market Committee
August 12, 2003 Presentation Materials -- Text Version

Presentation Materials (1.87 MB PDF)

Pages 100 to 110 of the Transcript

Appendix 1: Materials used by Mr. Kos

Page 1

Top panel

Title: Current U.S. 3-Month Deposit Rate and Rates Implied by Traded Forward Rate Agreements
Series: U.S. LIBOR fixing, 3-month forward rate agreement, 6-month forward rate agreement, 9-month forward rate agreement
Horizon: April 15, 2003 - August 8, 2003
Description: Forward rate agreements and U.S. Libor increased after the June FOMC meeting.

Middle-left panel

Title: U.S. Treasury Yields: 2-Year Note
Series: 2-Year Treasury Yield
Horizon: April 15, 2003 - August 8, 2003
Description: Two-year Treasury yields increased after the June FOMC meeting.

Source: Bloomberg

Middle-right panel

Title: U.S. Treasury Yields: 10-Year Note
Series: 10-Year Treasury Yield
Horizon: April 15, 2003 - August 8, 2003
Description: Ten-year Treasury yields increased after the June FOMC meeting.

Source: Bloomberg

Bottom panel

Title: U.S. Nominal 10-Year Treasury Less 10-Year Inflation-Indexed Treasury Yield
Series: Spread between 10-Year Nominal and Inflation Protected Treasury Yields
Horizon: January 1, 2000 - August 8, 2003
Description: The spread between ten-year nominal and inflation-protected Treasury yields has remained within a 100 basis point range in the past few years.

Source: Bloomberg

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Top-left panel

Title: 30-Year Mortgage Rates and the MBS Coupon Distribution: Amount Outstanding as of December 31, 2002
Series: MBS Coupon Distribution of Dollar Amount Outstanding
Horizon: As of December 31, 2002
Description: The largest dollar amount of MBS outstanding had a 6.5 percent coupon as of December 31, 2002, higher than the 6.05 percent mortgage rate.

Source: GNMA, FNMA, and FHLMC

Top-right panel

Title: 30-Year Mortgage Rates and the MBS Coupon Distribution: Amount Outstanding as of May 31, 2003
Series: MBS Coupon Distribution of Dollar Amount Outstanding
Horizon: As of May 31, 2003
Description: The largest dollar amounts of MBS outstanding were relatively evenly distributed between 5.5, 6, and 6.5 percent coupons as of May 31, 2003, slightly above the 5.48 percent mortgage rate.

Source: GNMA, FNMA, and FHLMC

Middle-left panel

Title: 30-Year Mortgage Rates and the MBS Coupon Distribution: Amount Outstanding as of June 30, 2003
Series: MBS Coupon Distribution of Dollar Amount Outstanding
Horizon: As of June 30, 2003
Description: The largest dollar amounts of MBS outstanding were relatively evenly distributed between 5.5, 6, and 6.5 percent coupons as of June 30, 2003, which was consistent with the 6.14 percent mortgage rate.

Source: GNMA, FNMA, and FHLMC

Middle-right panel

Title: 30-Year Mortgage Rates and the MBS Coupon Distribution: Fixed Rate MBS Duration
Series: Lehman's Fixed Rate MBS Duration Index
Horizon: January 2, 2003 - August 8, 2003
Description: MBS duration has increased sharply in the last couple months.

* Lehman's MBS index represents over 600,000 liquid, fixed-rate mortgage-backed pass-through securities issued by GNMA, FNMA and FHLMC.

Source: Lehman Brothers

Bottom panel

Title: 10-Year Treasury Yield and Estimated MBS Hedging Need
Series: 10-Year Treasury Yield, Estimated MBS Hedging Need*
Horizon: January 1, 2003 - July 31, 2003
Description: The ten-year Treasury yield and estimated MBS hedging need have been increasing since June.

* Based on convexity of all outstanding fixed-rate GNMA, FNMA, and FHLMC mortgage-backed pass through securities (15-year, 30-year, and balloons). Hedging Need = (Change in Security Duration * Amt Outstanding) / 10-Year Treasury Duration, where Pos. = Treasury Sale, Neg. = Treasury Purchase Return to text

Source: Bloomberg, Goldman Sachs

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Top panel

Title: 10-Year Swap Spread
Series: 10-Year Swap Spread
Horizon: April 15, 2003 - August 8, 2003
Description: Despite a sharp decline in the last week, the ten-year swap spread has increased since the June FOMC meeting.

Source: Bloomberg

Middle panel

Title: 20-Day Std Dev of Daily Change in 10-Year Swap Spread
Series: 20-Day Standard Deviation of the Daily Change in the 10-Year Swap Spread
Horizon: July 1, 1993 - August 8, 2003
Description: The 20-day standard deviation of the daily change in the 10-year swap spread increased sharply.

Source: Bloomberg

Bottom-left panel

Title: U.S. Corporate and Emerging Market Debt Spreads to U.S. Treasuries: U.S. Investment Grade Option-Adjusted Spread
Series: U.S. Investment Grade Corporate Option-Adjusted Spread
Horizon: January 1, 2003 - August 8, 2003
Description: The U.S. investment grade corporate option-adjusted spread has narrowed.

Source: Lehman Brothers

Bottom-right panel

Title: U.S. Corporate and Emerging Market Debt Spreads to U.S. Treasuries: U.S. High Yield OAS and EMBI+ Spreads
Series: EMBI+ Sovereign Debt Spread, U.S. High Yield Corporate Option-Adjusted Spread
Horizon: January 1, 2003 - August 8, 2003
Description: The EMBI+ sovereign debt spread and the U.S. high yield corporate option-adjusted spread have narrowed.

Source: Merrill Lynch, Bloomberg

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Top panel

Title: Selected 10-Year Government Bond Yields
Series: 10-Year Government Bond Yields for Mexico, Australia, Canada, Sweden, Germany, the U.S., and Japan
Horizon: April 15, 2003 - August 8, 2003
Description: Ten-year government bond yields have increased since the June FOMC meeting.

Source: Bloomberg

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Top panel

Title: Current 3-Month Euro-Area Deposit Rate and Rates Implied by Traded Forward Rate Agreements
Series: Euribor fixing, 3-month forward rate agreement, 6-month forward rate agreement, 9-month forward rate agreement
Horizon: April 15, 2003 - August 8, 2003
Description: Forward rate agreements have increased since the June FOMC meeting, however, the Euribor fixing remains relatively unchanged.

Source: Bloomberg

Middle-left panel

Title: Trade Weighted Dollar and the Japanese Yen: Trade Weighted U.S. Dollar
Series: Trade-Weighted U.S. Dollar
Horizon: January 2, 2003 - August 8, 2003
Description: The trade-weighted dollar has appreciated since the June FOMC meeting; however it remains below levels observed earlier this year.

Source: Bloomberg

Middle-right panel

Title: Trade Weighted Dollar and the Japanese Yen: Dollar-Yen Exchange Rate
Series: USD-Yen.
Horizon: January 2, 2003 - August 8, 2003
Description: The U.S. dollar has been appreciating against the yen over the past few months.

Source: Bloomberg

Bottom panel

Title: Major Japanese Yen Crosses
Series: Yen per Australian Dollar, Yen per Canadian Dollar, Yen per Euro, Yen per British Pound, Yen per U.S. Dollar
Horizon: May 1, 2003 - August 8, 2003
Description: Since the beginning of the year, the Japanese yen has depreciated against the Australian dollar, Canadian dollar, and Euro. The yen remains relatively unchanged against the British Pound and U.S. dollar.

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Top panel

Title: Currency Component of M1 (s.a.)
Series: Currency Component of M1 (s.a.) 1-Month Annualized Growth Rate
Horizon: January 2001 - July 2003*
Description: The currency component of M1 has declined.

* Estimated Value Return to text

Bottom panel

Title: Total Domestic Portfolio: Permanent SOMA Holdings, Long-Term RPs, Short Term Operations (RPs less Reverse RP Agreements) and Net Autonomous Factors (Absolute Values)
Series: Maintenance Period Average Levels of the Permanent SOMA Holdings, Long-Term RPs, Short-Term Operations, and Net Autonomous Factors
Horizon: December 11, 2002 - August 20, 2003
Description: Permanent SOMA holdings have been increasing as net autonomous factors increase.

Note: A positive movement in Net Autonomous Factors (absolute values) reflects a reserve drain. Level of Entire Portfolio reflects level of all net autonomous factors plus total Fed balances, net of borrowing.

Appendix 2: Materials used by Mr. Madigan

Material for Briefing on Monetary Policy Alternatives
August 12, 2003

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Exhibit 1
Key Financial Market Developments

Exhibit 1 includes one table and four charts that provide information on key financial market developments.

Top-left panel
Ten-year Yields

	Change June 24 to August 11 -basis points-
Treasury	110
Swap	113
Fannie Mae	111
AA	111
BBB	101

Top-right panel

Ten-year Treasury Note Volatility

The top-right panel consists of a time-series chart of realized and implied ten-year Treasury note volatility from May through August of 2003. The vertical axis has a range from 6 to 13 percent. A vertical line is drawn to indicate the June 2003 FOMC meeting date. Prior to the June 2003 FOMC, the spread between implied and realized volatility was quite small. However, immediately after the June FOMC, realized volatility jumped to about 9 percent and continued to increase until the beginning of August, when it reached a peak of almost 12 percent and then declined slightly to 11 percent by the end of the period. Implied volatility, on the other hand, remained at around 7 percent until mid-July and then increased to 10 percent at the end of July, and ended the period a bit above 9 percent, well below the level of realized volatility.

Middle-left panel
Ten-year Swap Spread

The middle-left panel shows a time-series chart of the ten-year swap spread from February 2002 to August 2003. The swap spread is measured in basis points, shown on the vertical axis. In general, there is a downward trend in the spread until mid-May 2003, when the spread hit its lowest point at 30 basis points. After mid-May, the ten-year swap spread started increasing and exhibits a large spike in early August to a level of about 70 basis points. Since then, market conditions have improved considerably, as shown by the significant decline in the spread to about 47 basis points by the end of the period.

Middle-right panel
Inflation Compensation

The middle-right panel is a time-series chart displaying inflation compensation from five to ten years ahead and over the next five years over the period from January to August 2003. The vertical axis has a range from 1 to 5 percent. A vertical line is drawn in the chart to note the June FOMC date. Prior to the June FOMC meeting, both five-year and five-year forward measures of inflation compensation exhibit a slightly negative trend. After the June FOMC meeting, inflation compensation from five to ten years ahead jumped from about 2.4 percent to 3 percent. Similarly, inflation compensation over the next five years increased from about 1.4 percent to almost 1.75 percent. Both time series provide information that is in contrast with the Michigan Survey results that show a steady long-term expected inflation and declining short-term expected inflation.

Michigan Survey
Expected Inflation
Percent

	June	July
Long-term	2.7	2.7
Twelve-month	2.1	1.7

Bottom panel
Treasury Yields

The bottom panel consists of a time-series chart of on-the-run two- and ten-year Treasury yields from May to August 2003, as shown in the horizontal axis. The left vertical axis corresponds to the two-year Treasury yield and has a range from 1 to 2 percent. The right vertical axis corresponds to the ten-year Treasury yield and has a range from 3 to 5 percent. There are three vertical lines drawn in the chart to represent the May FOMC date, June FOMC date, and date of the July monetary policy

testimony. The two-year and ten-year Treasury yields exhibit strong co-movement. At the May FOMC line, both two-year and ten-year Treasury yields declined and show a negative trend until the June FOMC meeting. The two-year Treasury yield started at 1.5 percent at the beginning of May and reached almost 1.1 percent before the June FOMC meeting. The ten-year Treasury yield started at about 3.75 percent and reached almost 3.25 percent just before the June FOMC meeting. At the June FOMC meeting, both yields jumped up and continued to increase over subsequent weeks. The run-up in rates can be attributed to the incoming corporate earnings reports that were better than anticipated, some better than expected economic data releases, and the news that the federal deficit was widening.

Exhibit 2
Policy Expectations and Choices

Exhibit 2 includes one chart and four text boxes that provide information about policy expectations and choices.

Top-left panel
Expected Federal Funds Rates*

The top left panel consists of a line chart of the expected federal funds rate derived from federal funds and Eurodollar futures. In particular, a dotted line shows the expected federal funds rate path on June 24, 2003 a day prior to the June FOMC meeting, and a solid line shows the expected federal funds rate path on August 11, 2003 the most recent observation. The horizontal axis has a range from August 2003 to December 2005. The vertical axis has a range from 0.5 to 4.5 percent. The June path begins at about 0.75 percent and ends at 2.25 percent. The August line, which is strictly above the June line, starts at 1 percent and ends slightly above 3.5 percent (December 2005), and suggests that the market participants thought that the Committee will begin tightening policy in the spring of 2004.

* Estimates from federal funds and eurodollar futures, with an allowance for term premia and other adjustments. Return to text

Top-right panel
Desk Survey of Primary Dealers

- All 22 dealers expect no policy change at this meeting:
  - 16 expect unchanged risk assessment.
  - 4 expect growth risks to downside.
  - 2 expect balanced risks.

Middle-left panel
Arguments for Easier Policy

- Greenbook credible, but prefer more rapid progress against slack and, perhaps, a greater inflation buffer.
  - Or may want more insurance.
- Aggregate demand could be weaker than in Greenbook.
- Aggregate supply could be stronger than in Greenbook.

Middle-right panel
Arguments for Unchanged Policy

- Greenbook credible and acceptable.

- Early evidence of accelerating demand.
- More fiscal stimulus coming on line.

- Rise in yields may signal firming economy.
- Apparent rise in inflation expectations.

Bottom panel
Assessment of Risks

- Developments over intermeeting period would seem to call for an unchanged assessment of risks.
  - Offsetting effects of strong incoming data and backup in rates suggest balanced risks to growth.
  - Continued low inflation, strong productivity, weak labor market, and a small downward revision to staff forecast suggest downside risks to inflation.
- A relatively high hurdle for changing the risk assessment today.

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