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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

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Board of Governors — February 20, 1941

Henry H. Edmiston — Trip to Chicago

## General market outlook

The bankers in Chicago feel that the decline in the Government security market since the first of the year has gone a long way in correcting the artificial level of rates which resulted from the rapid rise in prices after the election. In general, they feel that forces tending to push prices lower outweigh on balance those tending to increase prices. There is a considerable difference of opinion, however, as to the extent to which prices are likely to decline. Some bankers feel that the tremendous volume of Treasury financing over the near future combined with increased demands for loans and for new capital by corporations will produce a substantial rise in interest rates. The rise in rates would, of course, be more pronounced if the Federal Reserve System obtains authority to increase reserve requirements and uses it. On the other hand, some of the bankers feel that the rise in interest rates will be slow and believe that the longest bond outstanding, the 1960-65, may stabilize at somewhere around 2 1/2 per cent as compared with the current yield of about 2.30 per cent.

## Recent market operations

The Chicago banks ordinarily do little in the market during the early part of the year except to acquire Treasury bills for the purpose of supplying their customers with tax-exempt securities for the April 1 tax date. This year is no exception to the general rule. The Continental Illinois, however, has started on a buying program of Treasury bonds on a scale down. During the last two weeks they have acquired $5,000,000 of bonds under this program. The entire program calls for purchases of $25,000,000 with $5,000,000 to be bought on each 1/2 point decline in the market. The Continental also holds its full allotment of about $10,000,000 on the last issue of defense notes. The increase of $7,000,000 in its holdings of guaranteeds represents purchases of H. O. L. C. notes maturing May 15 which can be used for April 1 tax avoidance.

The First National Bank has recently sold $5,000,000 of its March note rights and purchased an equal amount of the 2 1/4s of 1951-53. Thus the bank is, in effect, doing its own refunding as its tax position does not permit buying taxable securities unless they can obtain the full tax equivalent yield. The bank now has only $2,000,000 of note rights left and, no doubt, these will be refunded in the market in a similar fashion. The Northern Trust Company has held its full allotment of the new defense notes and purchased about $5,000,000 additional in the market, partly against sales of

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rights. The City National Bank also held their allotments of the two taxable notes and purchased enough in the market to bring their holdings up to a total of $7,000,000. The Harris Trust sold its allotments of defense notes in the market and has made few changes in its other holdings. The accompanying table shows recent changes in the portfolios of leading Chicago banks.

GOVERNMENT SECURITY HOLDINGS OF CHICAGO BANKS
(In millions of dollars)

| | Continental Illinois | | First National | | Northern Trust | | Harris Trust | | City National | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Dec. 31 | Feb. 12 | Dec. 31 | Feb. 12 | Dec. 31 | Feb. 12 | Dec. 31 | Feb. 12 | Dec. 31 | Feb. 12 |
| Bills............... | 232 | 189 | 1 | 128 | 51 | 65 | 3 | 22 | 2 | 22 |
| Notes............... | 36 | 46 | 48 | 45 | 12 | 15 | 39 | 38 | 8 | 15 |
| Bonds: | | | | | | | | | | |
| Up to 5 years.... | 1/ | | 42 | | 6 | | 4 | | 1/ | |
| 5 to 10 years.... | 4 | | 106 | | 0 | | 4 | | 1/ | |
| 10 to 20 years... | 300 | | 170 | | 1/ | | 9 | | 0 | |
| Over 20 years.... | 100 | | 1/ | | 1/ | | 0 | | 0 | |
| Total bonds... | 404 | 407 | 318 | 321 | 6 | 6 | 17 | 18 | 1/ | 1/ |
| Guaranteeds........ | 4 | 11 | 35 | 36 | 42 | 46 | 2 | 1 | 21 | 21 |
| Total direct and guaranteed...... | 675 | 653 | 402 | 530 | 111 | 132 | 60 | 79 | 31 | 58 |

1/ Less than $500,000.

## Views on Treasury Financing

### General

The Chicago banks feel that the Treasury should take no chances on the first issues of taxable bonds because of general market conditions, because of the continued tense international situation, and because of the unfavorable reaction to the recent issues of defense notes. They believe that the Treasury should give holders of the bond and note rights an option of converting into at least two and possibly three new taxable securities with premiums adequate to assure complete conversions. Any cash offerings should also be generously priced. Even though the premiums may seem unnecessarily high, it is desirable to have investors well pleased in order that the market will be more receptive to subsequent cash financings. Although the Chicago banks may tend to exaggerate the picture somewhat, their views carry added weight because of their large correspondent accounts. At the time of each Treasury financing country banks throughout the area call up these banks to ask what they think about the particular offerings and it is helpful for the Chicago banks to give the offerings good publicity.

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Specific issues and taxable differential

The bankers generally mentioned a 3/4 per cent short note, a 2 1/2 per cent bond of around a 10-year maturity, and a long 2 3/4 per cent bond as issues which would be favorably received by various classes of investors. In Chicago the Harris Trust and the City National banks would only be interested in the note, while the Northern Trust would probably be interested in an intermediate-term bond. The Continental would subscribe to any bonds offered for cash and would be buyers in the secondary market both on cash and refunding issues unless prices advanced too sharply. The First National Bank, which now pays Federal income taxes, would not be interested in any taxable securities unless they showed the full tax equivalent yield.

The Chicago people do not have much confidence in their judgment as to the proper differential between a taxable and nontaxable Treasury bond. The lowest differential mentioned was about 0.30 per cent, while the highest was about the full tax equivalent. They feel that there are a large number of potential purchasers for taxable bonds that were not in the market for taxable defense notes at the existing low rates. The insurance companies, the savings banks, banks not subject to Federal normal income taxes (a group in which a large number of country banks fall), nonprofit-making institutions, and trust funds of individuals were mentioned as the more important investors of this type.

In this connection, the views of people close to the corporate market, such as investment bankers and bank trust officers, were quite in contrast to those expressed by the commercial bankers. One investment banker, for example, expressed the opinion that the Treasury could sell a large volume of 10-year bonds for 2 1/4 per cent, a rate which would be above the current market on high-grade corporate bonds and railroad equipment trusts of this general maturity range. The principal trust officer of a large Chicago bank mentioned that he had a large number of trusts which would be delighted to obtain taxable intermediate Treasury bonds at 2 1/2 per cent or long Treasury bonds at 2 3/4 per cent, as both rates would be out of line with current quotations on high-grade corporate bonds.

Some bankers expressed concern about the secondary market on the issue or issues offered for conversion on the ground that potential investors will hold off awaiting the cash offerings expected shortly. Although there is a large volume of excess funds in the hands of these investors, they do not know how much may be absorbed by allotments on their subscriptions to new taxable securities issued for cash and consequently they will not be inclined to buy the new refunding issues in the market unless prices decline substantially after trading begins. According to the Dow-Jones ticker Tuesday morning the Secretary announced he would do the refunding next week and raise new cash the first week in March. The banks' views on this subject may change, therefore, when they learn that the new cash will be raised through increasing Treasury bill issues.

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Most of the bankers in discussing the differential between taxable and nontaxable Treasury bonds consider that a normal tax rate of 30 per cent applying to 1941 incomes is almost certain and think that in making calculations perhaps an even higher rate should be used. The question also arises as to the effect on the market as a result of the fact that many potential investors who do not pay corporate income taxes at present may soon be in that position. For example, a number of banks will soon have to pay income taxes because of increased income from loans, and because of refundings of their large holdings of nearby maturities of Government securities which now provide them with tax-exempt income. One banker also mentioned the fact that he was talking with an executive of a large insurance company recently who expressed concern over the future tax status of insurance companies. Although insurance companies now have a considerable margin before they would have Federal income taxes to pay, it is possible that the tax laws will be changed so that they will not obtain the present high deductions for tax purposes. To the extent that insurance companies anticipate such changes in tax laws, they will be inclined to hold on to their present nontaxable Government securities rather than switch to taxable issues when a spread develops.

Miscellaneous comments

Several Chicago bankers expressed the opinion that there is a large market for certain possible new types of taxable savings bonds. This is particularly true if the bonds pay a current return of 2 1/2 per cent or better. Many accounts in the banks' trust departments need current income, especially where there are different beneficiaries for the income and the principal of the trust. In this connection, it is important that permission be given so that the new savings bonds may be transferred directly to beneficiaries without having to be redeemed at a penalty. One banker also mentioned that, in order to reduce the demand liability to the Treasury, savings bonds paying an annual income might, in the future, be redeemed either in cash or in some specified outstanding market bond at the option of the Treasury.

The Chicago banks continue to show an increase in loans, particularly term loans. The First National Bank, which is a leader in the term loan field, shows an increase of about $40,000,000 since a year ago. While many recent new loans may be attributed to the increase in general business activity resulting from the national defense program, Chicago banks do not have such a large amount of direct defense loans. For example, the First National Bank has made commitments for about $18,000,000 of direct defense loans, on which about $12,000,000 has been disbursed. About $3,500,000 of this amount represents plant facilities loans and the remainder loans on supply contracts.

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## List of Persons Interviewed

Continental Illinois -- Mr. Knight, Vice President
Mr. Drew, Vice President (Trust Department)
Mr. Bennett, 2nd Vice President (Trust Department)

First National -- Mr. McCloud, Vice President
Mr. Grier, Assistant Vice President

Harris Trust -- Mr. Brinkman, Vice President
Mr. Elliot, Vice President
Mr. Wayne

Northern Trust -- Mr. Spaulding, Vice President

City National -- Mr. Wigeland, Assistant Vice President
Mr. Daniel

Harris, Hall, & Company -- Mr. Hall, President

Federal Reserve Bank -- Mr. Schaller
Mr. Sihler
Mr. Dawes