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November 30, 1936

GOVERNMENT SECURITY MARKET

RECENT NEW YORK VISITS

(This memorandum has been prepared at Chairman Eccles' request, and in view of its important bearing on the Board's problems, he has asked me to furnish a copy to each of the Governors.

E. A. G.)

November 30, 1936

To: The Board of Governors

Subject: Government security market.

From: L. M. Piser

Recent New York visits.

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The general trend of investment policy during the past year or more has been toward a gradual extension of maturities, with smaller demand for short-term notes and larger demand for Treasury bonds. Commercial banks, which in past years have concentrated their holdings of Government's largely in Treasury notes and other short-term issues, have extended maturities to include intermediate bond issues. These intermediate issues still have a fairly satisfactory yield, around 2 percent, and at the same time are not subject to quite as much risk of price decline as is the case with longer-term bonds.

The policy of country banks toward the Government security market appears to be somewhat erratic. On the one hand, country banks apparently feel that, in view of the increase in Government security prices over the past four years, they subject themselves to considerable price risk by purchasing Government's. On the other hand, the small income of most banks, together with the necessity of at least earning expenses, makes additional purchases necessary.

Savings banks appear to be purchasing Government securities in fairly substantial volume. Savings banks in New York State during the first six months of this year increased their holdings of direct and guaranteed obligations by \$160,000,000. During this period their purchases were

concentrated almost entirely in intermediate and long-term Treasury bonds, with the largest increase in those issues maturing in 10 years or more, including the new Treasury bond issues floated during this period.

Until the past year or so wealthy individuals have generally preferred to purchase Treasury notes, because of their greater tax exemption. As the notes have approached a one percent basis these individuals have tended to invest more largely in Treasury bonds, since the difference in yields is now sufficiently large to enable them to secure a higher net return despite the higher tax cost. It is only in the case of extremely large estates or individuals with extremely large incomes that the difference in tax exemption is still sufficient to make it advisable to purchase notes, and even in these instances Treasury notes are generally purchased for trust funds only where a substantial amount of liquidity is desirable.

There has also been some tendency for corporations holding Government securities to lengthen their maturities. It appears that corporations with surplus funds that they wish to invest in Government's have been selling some of the shorter-term notes and purchasing either long-term notes or bonds.

Insurance companies generally prefer either the high coupon or long-term Treasury bonds. They purchase high coupon issues because of the larger amount of tax exemption. Long-term bonds are purchased because the cash demands on insurance companies are sufficiently regular to enable them to hold such issues to maturity.

Most dealers and investors in Government securities feel that the Treasury bond market will at some time in the indefinite future decline substantially. This belief apparently is based upon the fact that Treasury bonds have in the past sold at very much lower levels than at present, and that increases in short-term interest rates have generally been followed by decreases in the price of long-term bonds. This position is questioned by certain individuals who are following the market. Although short-term and long-term interest rates have in the past shown some relationship, there have been periods when an increase in short-term interest rates has been followed by a further decrease in long-term rates. In the current situation absorption of excess reserves will probably inevitably result in an increase in short-term interest rates and a decline in the price of Treasury notes. On the other hand, it is entirely conceivable that long-term Treasury bonds will hold to something like their present levels. The other factors in the situation are the high level of bank deposits; the substantial amount of idle funds; the pressure upon institutions of the necessity of earning expenses; the probably negligible issuance of new foreign securities in this market; probably a small amount of domestic issues reflecting the high level of corporate working balances; the small amount of cash funds required by the Treasury; and purchases of securities by the Treasury for social security accounts, only partly offset by sales by the Treasury for account of the Postal Savings System in the event that banks wish to reacquire their Postal Savings deposits.

These facts and opinions were obtained from discussion with Dr. Burgess and Mr. Matteson of the New York Federal Reserve bank and the following others: Mr. Levy of Salomon Brothers; Mr. Mills of Discount Corporation; Mr. Baker of Brown Brothers, Harriman; Mr. Steiwert of Childs; Mr. Smith of Devine; Mr. Lanston of the First Boston Corporation; Mr. Rich of Hansiatic; Mr. Woodward of Moody's; Mr. Sachs of the Lehman Corporation; Mr. Gill of the Bank of the Manhattan Company; Mr. Smith of the City Bank Farmers Trust Company; Mr. Marks, an independent investment securities counsel; Mr. Stample of J. & W. Seligman; and Mr. Miller of the Savings Banks Trust Company.