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Monetary*Trends*

THE FEDERAL RESERVE BANK of ST. LOUIS

Expectations and Fundamentals

Secondary-market yields on Treasury Inflation-Indexed Securities (TIIS) increased during the months prior to January 2000, and have declined since then (see chart). This pattern resembles the time path of the Nasdaq Composite Index and other major stock-market indexes. Both patterns may reflect investors' increasing optimism about near-term economic fundamentals leading up to early 2000, followed by a shift toward pessimism.

Financial-asset prices and yields provide important insights into investor expectations about the economy. Market yields on TIIS represent investors' required annual real return during the life of the security. This yield approximates the *ex ante* (i.e., forward-looking) riskless real interest rate because the holder faces no default risk or inflation risk.

What factors determine the *ex ante* riskless real interest rate? Federal Reserve Bank of St. Louis President William Poole explained the relatively high real interest rate observed in late 1999 as follows:

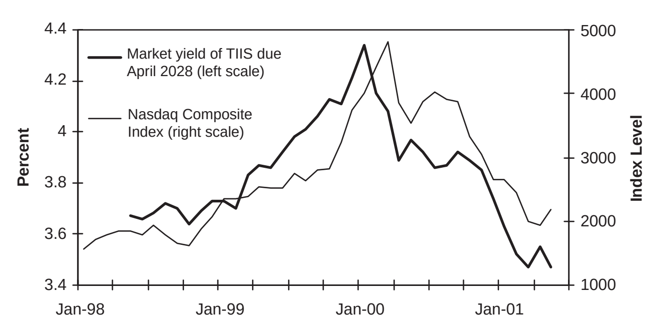
> Funds invested in the bond market have to compete with funds invested in productive businesses. . . . [B]usiness investment spending is strong; . . . corporate earnings have grown smartly; . . . stock market valuations reflect confidence in the future; . . . economy-wide productivity growth has surged since 1995. These are all signs of a high return on invested capital. . . . [T]he high real rate in the bond market reflects the fundamentals . . .[1]

Consequently, the decline in TIIS yields since January 2000 suggests that future returns on invested capital now are not expected to be as high as was the case just a few quarters ago. Indeed, business investment spending has decelerated, corporate earnings have fallen, stock-market valuations have diminished, and the measured labor-productivity growth rate was negative during the first quarter of 2001. These and other signs point to a greatly reduced level of confidence in at least the near-term performance of the U.S. economy. As the chart indicates, stock-market indicators such as the Nasdaq Composite Index may reflect essentially the same ebb and flow of investor expectations of future economic performance that determine TIIS yields.

Long-term (i.e., several-year) forecasts of economic growth, productivity growth, business investment spending, and corporate earnings growth are virtually impossible to make with consistent accuracy. Therefore, the short-term volatility we observe in TIIS yields and other indicators of *ex ante* real expected returns probably reflects, in large part, the changing forecasts by investors of the economic fundamentals expected during the immediate future.

—William R. Emmons

[1] Poole, William, "Are Real Interest Rates Too High?" Speech delivered to the Money Marketeers of New York University, September 21, 1999, www.stls.frb.org/general/speeches/990921.html.



Source: *Wall Street Journal* for Nasdaq Composite Index and *New York Times* for TIIS. Observations are monthly averages of daily values. Last observation: May 2001.