The Federal Reserve has aggressively confronted the ongoing recession by cutting the federal funds rate target to a range between zero and 25 basis points and implementing a number of quantitative credit-easing policies. Yields on Treasury bills and notes have decreased sharply in response both to these actions and to weak economic activity. As shown in the chart, decreases in short-term yields preceded those in longer-term yields. Short-term yields on 90-day Treasuries fell from approximately 5 percent to less than 0.25 percent; later, longer-term yields (10-year) decreased to below 3 percent.

Lower long-term market yields are instrumental to the goals of an expansionary monetary policy. But Treasury yields are unusual because there is no default risk; this lowering of Treasury yields needs to be transmitted to yields on other securities. However, this transmission from the long-end of the Treasury yield curve to securities such as corporate bonds and mortgages has proven more difficult than in previous recessions. Corporate and mortgage-backed yields contain a default-risk premium that is reflected in a positive yield spread over Treasury securities. A larger-than-usual risk premium may cause a weak response in private yields. The U.S. corporate bond market is large, with $9.8 trillion in outstanding debt—1.5 times the amount of outstanding Treasuries. The U.S. mortgage market is even bigger—$14.7 trillion at the end of 2008, of which $8.2 trillion is securitized. Given the size of the underlying markets, cutting the cost of capital to firms and households by reducing the yields required on long-term corporate bonds and mortgages is a key policy objective. The top panel of the chart shows that yields have decreased little so far in this recession. On the contrary, the spreads between both investment (Aaa)- and speculative (Baa)-grade corporate bond and Treasury note yields have skyrocketed to unprecedented levels.¹ For instance, the spreads between 8- to 15-year mortgage-backed securities (MBS), computed by averaging the yields of private-label securities with ratings higher than BB, are from Bloomberg/Bear Stearns.

¹ Long-term corporate bond yields are from Moody’s. Data for 8- to 15-year mortgage-backed securities (MBS), computed by averaging the yields of private-label securities with ratings higher than BB, are from Bloomberg/Bear Stearns.

---

Taming the Long-Term Spreads

Viewed expressed do not necessarily reflect official positions of the Federal Reserve System.