FVCM

U.S. Market Report

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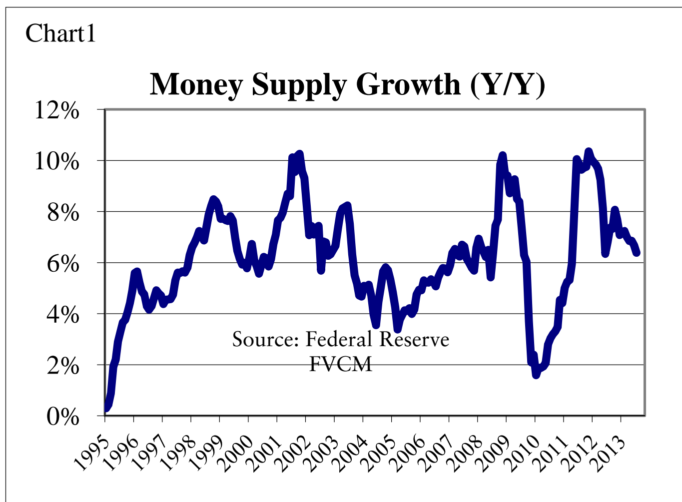
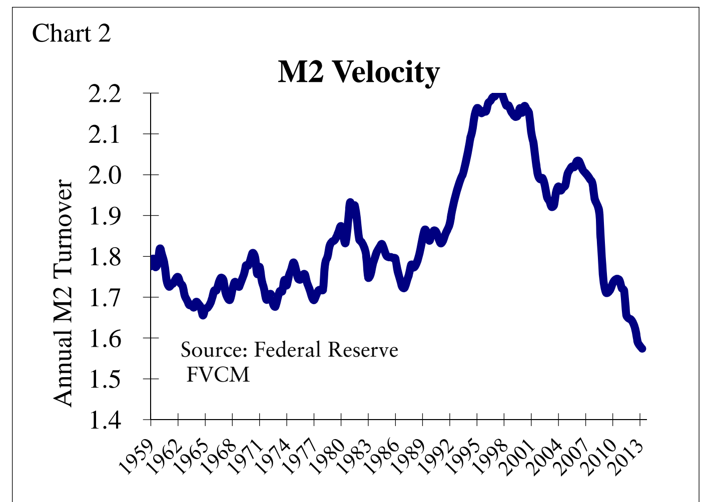
Tapering on Hold

From our reading, the current consensus seems to be that QE3 will be gradually reduced from its current pace by no later than the first quarter of 2014. This is possible, but the consensus has been wrong. The Federal Reserve is currently purchasing $45 billion in U.S. treasury securities and $40 billion of mortgage backed securities per month (QE). Previously, the consensus was that QE would be tapered, i.e., reduced, beginning this past September. That obviously never happened. The Fed has said that changes to monetary policy would be data dependent and specifically pointed at unemployment, which is still too high at 7.2%. However, there is a larger issue that should not be overlooked: A central responsibility of the Fed is to provide sufficient money and credit so as to facilitate a normal level of spending in the economy. If real economic growth is targeted at 2.5%, and the Fed plans to allow a 1% inflation rate, nominal spending must grow at a 3.5% annual rate. However, nominal spending has been growing at only a 3.1% year-over-year rate. Clearly, there is not enough money and credit being supplied to produce 3.5% growth in nominal spending.

Money in Demand

Bank deposits have been growing at a healthy pace, but spending has been soft because people are still scared. Both corporations and individuals have remained very risk averse since the crisis of 2008-9 and have been accumulating large cash balances. It's not just Apple and Microsoft hoarding money. Corporate cash balances, which include short term liquid investments, are approaching $2 trillion. Individuals have been net sellers of equities in recent years and have been more content to sit on money in the bank, even though the returns approximate zero. As of September, the M2 money supply was up 6.4% year-over-year (see Chart 1), but nominal growth has been a paltry 3.1% because people are sitting on the money rather than spending it (Chart 2 shows the "velocity," or turnover of money).

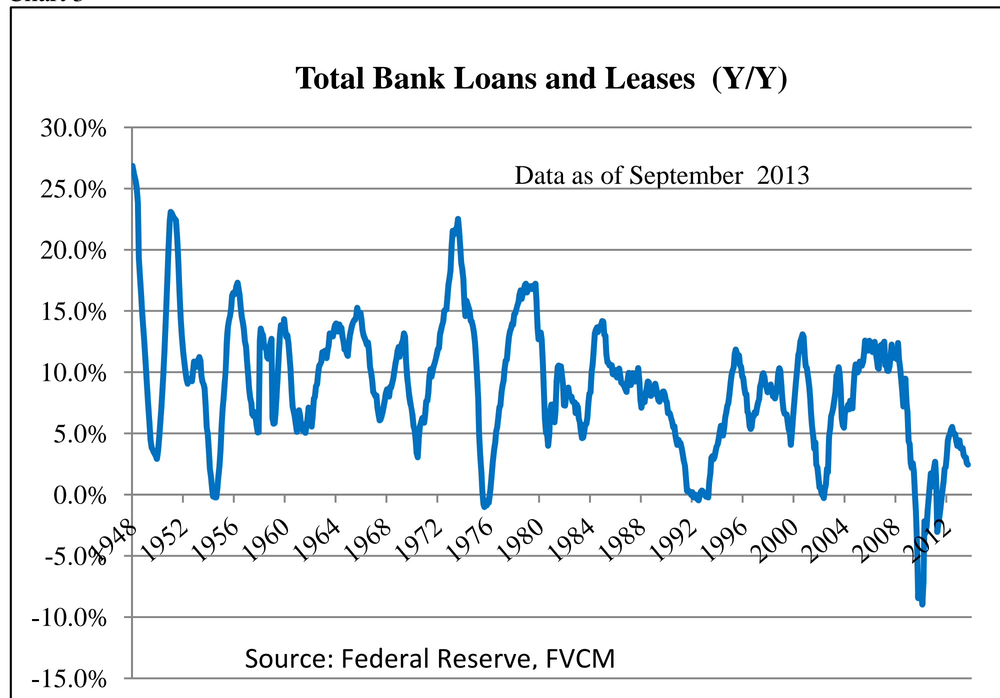




Bank Lending Doldrums

With the demand for money high, the Fed has had to be a primary supplier of liquidity because not enough money is being created through bank lending. When a bank makes a loan, a bank deposit is created in the borrower's name. That bank deposit can be spent and is a form of M2 money. The problem is that growth in bank loans and leases has been anemic, rising only 2.5% year over year as of September (see Chart 3). There are many reasons why bank lending has been weak: 1) People have been trying to reduce debt since the financial crisis and the demand for credit is weak; 2) There have been new, stricter regulations (Dodd-Frank Act) put on banks that has had the effect of tightening lending standards, and 3) the new Basel III Accord requires that banks hold greater amounts of capital relative to assets such as loans. Other than bank lending, the other way for money and liquidity to be created is for the central bank to purchase assets such as treasury securities from the public. For example, when the Fed purchases a mortgage backed security (MBS) from a non-bank, a deposit is created at the seller's commercial bank (this is part of M2 and is a bank liability). At the same time, the Fed creates a reserve deposit for that commercial bank (this is an offsetting bank asset) with the central bank. In this process money is created. Essentially, the Fed is swapping a MBS (non-money) for a bank deposit (M2 money*). The only reason that the M2 money supply has been able to grow at a 6% rate in the face of such weak bank lending, is because the Fed is creating M2 liquidity through the QE process of buying securities from the public.*

Chart 3

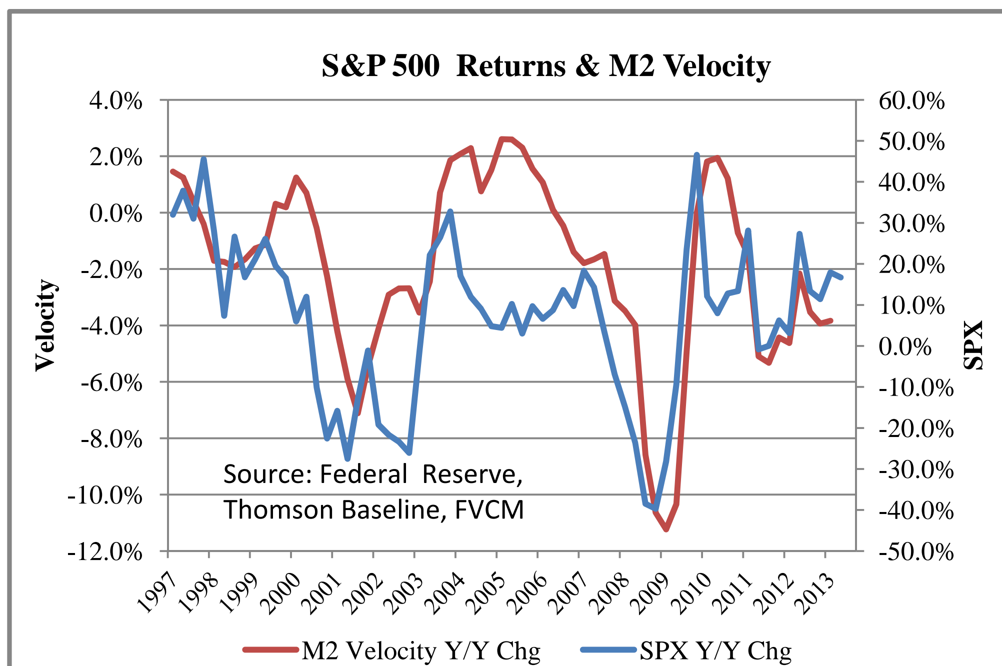


The Stock Market is Fuel for Spending

The stock market is a critical element when it comes to spending and may lead to the end of QE. As pointed out in our opening paragraph, nominal spending has to grow at a 3.5% rate in order for real growth to reach 2.5% in an environment of 1% inflation. And because people are hoarding money, the Fed has to make sure that money growth is even faster than the 3.5% spending rate. However, if confidence were to return and people started loosening the purse strings, spending growth could accelerate as people spend *existing* money balances. In other words, if the velocity of money begins to accelerate, the Fed would have to reduce the amount of money creation and QE. Why would velocity accelerate? If the stock market continues to produce strong positive returns, people will feel more confident and richer through the "wealth effect" and be willing to draw down on money balances. As

shown in Chart 4, there has been a positive "leading" relationship between the change in the S&P 500 and the turnover of money.

Chart 4



The End of QE

The Fed has said that QE is data dependent. As we have tried to argue here, QE will continue as long as it is necessary to augment bank lending and produce enough money and liquidity to support a minimum of 3.5% annualized growth in nominal spending. So if bank lending picks up, perhaps QE can be reduced. Or if the stock market continues to move higher and people start to spend the cash they already have, perhaps QE can be reduced. But the tell-tale sign will be faster spending. The advanced release of third quarter GDP, which came out on November 7th, showed nominal spending rising at a 4.8% annualized rate on a quarter-to-quarter basis, although still up only 3.1% year-over-year. We'll have to see whether the Q/Q figure may be some sort of seasonal blip or if faster spending is here to stay. The consensus may be correct this time and QE may be tapered starting by the first quarter of 2014, but there is going to have to be some more evidence that spending growth is accelerating on a sustained basis. The fourth quarter advanced estimate of GDP, which comes out on January 30th, as well as the third quarter revisions, will be closely watched. We'll see it in the data.

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