CENTER FOR FINANCIAL STABILITY

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HIGHLIGHTS

BASED ON DATA RELEASED AT 9:00 A.M. EST, DECEMBER 19, 2012

QE3 AND MARKETS: CFS MONEY SUPPLY STATISTICS

DATA FOR NOVEMBER 2012

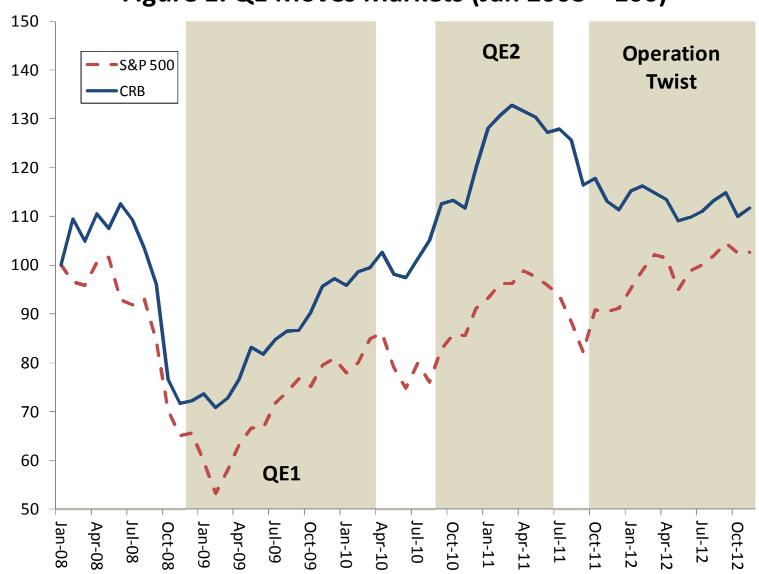
The move by the Fed to purchase $45 billion per month in longer-term Treasury securities will undoubtedly influence financial markets into 2013. However, the impact on the real economy and CFS monetary aggregates may be somewhat more muted – if history serves as a guide.

Renewal and reinvigoration of quantitative easing (QE) may unleash some benefits to output, yet at a potential cost of either higher inflation or another asset price bubble. For now, the costs appear to be minimal. However, CFS monetary aggregates and components should help provide an early warning regarding the potential for a burst of inflation or steep decline in asset prices.

QE and the Markets

Equity and commodity markets are highly responsive to surges in liquidity generated by QE. For instance, the S&P 500 gained between 26% and 30% coincident with the last two episodes of QE. Similarly, the Commodity Research Bureau (CRB) index gained between 21% and 39%. As soon as the extraordinary operations ceased, markets edged lower. The CRB index was alone in receiving a modest boost of 6% in the period between QE1 and QE2.

Figure 1. QE Moves Markets (Jan 2008 = 100)



Source: Federal Reserve, Bloomberg, and the Center for Financial Stability.

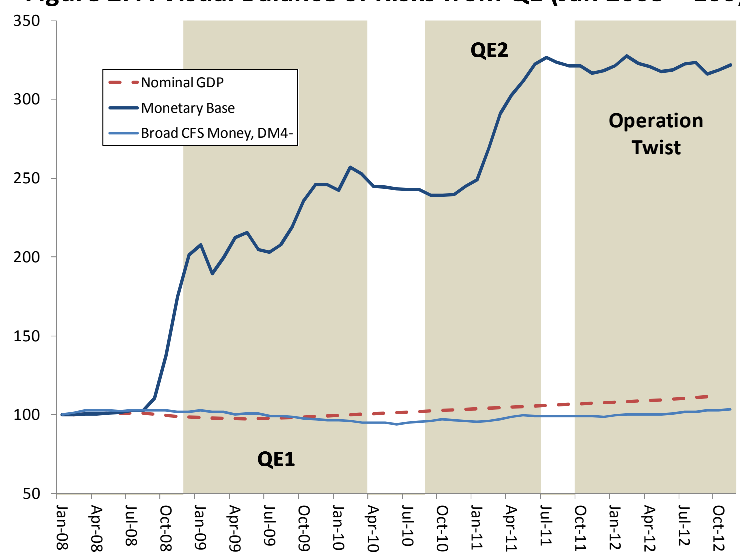
Operation Twist had a more limited and disparate impact. The CRB index edged lower during the period coincident with the Fed's selling Treasury securities with maturities of 3 years or less and purchasing an equal and offsetting amount of bonds with remaining maturities of 6 to 30 years. The more limited impact of Operation Twist on commodity markets was perhaps due to sluggish demand as well as the emergence of new supplies of energy. In contrast, equity markets remained firm as the search for yield drove investors into stocks.

Going forward, the Fed's stated objective of preserving the purchase of Treasury and mortgage securities totaling $85 billion per month could boost total reserves by another 63% by the end of 2013. If history repeats and other factors remain subdued, stocks and commodities stand to gain. However, this seeming free lunch for markets will undoubtedly be at a longer term cost.

QE, the Economy, and Monetary Aggregates

The relative size and scope of the Fed's nontraditional monetary operations readily raises questions regarding benefits relative to potential costs. Since the beginning of 2008, the monetary base is up 220% with gains greater than at any time since the data became available in 1918. In contrast, nominal GDP is up a scant 11%. Typically, the broadest CFS Divisia M4 closely tracks nominal GDP. However, the broadest CFS monetary aggregate is barely up 1% since the beginning of 2008. So the real economy is likely benefiting from the nontraditional monetary expansion.

Figure 2. A Visual Balance of Risks from QE (Jan 2008 = 100)



Source: Federal Reserve, Bureau of Economic Analysis, and the Center for Financial Stability.

However, the unprecedented swell in the balance sheet suggests that costs will likely present over the medium term. The most probable challenges for market participants will stem from either a more rapid advance in inflation than is presently expected or a financial bubble with special risks emanating from bond and currency markets. Disturbances in monetary and financial data will likely present, as turning points near.

Observations this Month

The latest CFS monetary aggregates suggest that the economy has bottomed and is beginning to recover, albeit at a tepid pace. If US authorities can develop a patchwork solution to the fiscal cliff, the US economy is on course to grow by about 2% to 2.5% in 2013. The CFS Divisia M4- the broadest aggregate excluding Treasuries grew by 4.5% in November 2012 on a year-over-year basis. This represents the highest advance in 17 months. Nonetheless, the expansion was largely due to a less pronounced contraction in institutional money market funds and commercial paper.

Figure 3. Major CFS Monetary Aggregates and Reserve Balances, % year-over-year

	2007	2008	2009	2010	2011	Jun-12	Jul-12	Aug-12	Sep-12	Oct-12	Nov-12
CFS DM4	7.3%	8.4%	-4.9%	-0.7%	0.9%	2.2%	2.9%	3.3%	4.3%	4.4%	5.2%
CFS DM4-	7.3%	2.6%	-5.0%	-0.6%	2.8%	2.0%	2.5%	2.5%	3.7%	3.9%	4.5%
CFS DM3	8.1%	3.0%	-2.3%	0.1%	3.6%	3.5%	3.6%	3.3%	4.3%	4.5%	4.9%
Reserves	0.0%	1801.5%	38.8%	-5.4%	48.2%	-6.6%	-6.6%	-5.1%	-7.7%	-6.9%	-2.8%

Source: Center for Financial Stability and Federal Reserve Board (total reserves of depository institutions).

About CFS Money Supply

CFS Divisia monetary measures were developed under the direction of Professor William A. Barnett - one of the world's leading experts on monetary and financial aggregation theory. CFS money supply data are essential, especially since the Federal Reserve ceased production of M3 in 2006. Similarly, Divisia measures are superior, as they accurately weight various classifications of money from cash to leverage in the shadow banking system.

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Additional information: www.CenterforFinancialStability.org

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