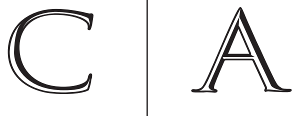

CAMBRIDGE ASSOCIATES LLC

U.S. MARKET COMMENT

WHERE HAS ALL THE MONEY GONE?

February 2004

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Where has all the Money Gone?

A money management firm titled a recent research piece: "What's wrong with the money supply?" Indeed, this nicely sums up the prevailing sentiment about monetary aggregates, which, despite arguably the most aggressively stimulative Federal Reserve in history, have recently posted some of the slowest growth numbers (including some outright declines) since the Fed began to track the data in 1959. While a slowdown in money growth is not *ipso facto* bearish for equity markets, it bears watching, as a continued deterioration in monetary aggregates could have adverse consequences.

We do not always pay such close attention to money supply figures, but as we have been arguing for some time that U.S. markets are experiencing a liquidity-driven rally, the potential for that liquidity to dry up is certainly of interest. Further, while we continue to believe the Fed and its tightening plans hold the key to the duration of the equity rally, a slowdown or decline in money supply growth is somewhat analogous to a Fed rate hike. Therefore, continued deterioration in monetary aggregates could negatively impact equity markets in much the same way as an *unexpected* Fed rate hike, as most investors are not expecting the Fed to tighten before June *at the earliest*.

For the six months ended January 15 (the latest data available), M3 rose at an anemic annual rate of 0.71%.[1] This is the slowest six-month rate of growth since 1994, and indeed, the slowest M3 has *ever* grown excluding the early 1990s and a brief period in 1969.[2] In fact, from August 15 to December 15, M3 *fell* by 1.0%, its largest four-month decline ever, and only the second time M3 has fallen for four consecutive months. Longer-term measures have also turned down, with year-over-year M3 now growing at the slowest rate since 1995, and the three-year average annual percentage change, while still a relatively healthy 7.3%, falling fast: it was above 9% as recently as July.

There are many differences between today and the last period of slow monetary growth. BCA Research points out that its "Financial Stress Index" is far lower today—indicating a healthier financial system—than in the early 1990s, when weak money supply growth went hand in hand with the savings and loans crisis. Further, it is worth noting that while the economy suffered in the early 1990s, equity markets did quite well. From the time the six-month annualized growth of M3 dropped below 1% in August 1991 to when it finally began to show sustained growth again in mid-1994, the S&P 500 returned 29.0% (AACR of 8.9%), while the Nasdaq Composite soared 43.8% (AACR of 12.9%). Finally, in the early 1990s valuations were significantly lower than today, short rates were 3% rather than 1%, and markets were not dealing with the aftermath of one of history's great manias.

Because money supply is affected by many factors, there are a variety of explanations for the sharp drop in growth rates. Many observers say not to worry: investors have simply been draining money market funds to pay for recent equity purchases. This explanation, however, assumes those who are selling equities are using the funds to pay off a loan or shrink other liabilities; otherwise, money supply would be unaffected. Another view is that the recent decline in real estate

[1] We use seasonally adjusted M3 data for this paper because M3 is the broadest measure of U.S. money supply, and also because it has a much longer history than MZM, the broadest measure of *liquid* money. We prefer the seasonally adjusted data because they tend to smooth out recurring fluctuations and give a more accurate picture of long-term trends.

[2] This is not the first time money supply has faltered while the Fed was easing. While the 1969 slowdown was associated with an inverted yield curve, the curve in the early 1990s was positive and quite steep, with the spread between the Fed funds rate and the ten-year Treasury yield at times approaching four percentage points as the Fed eased aggressively.

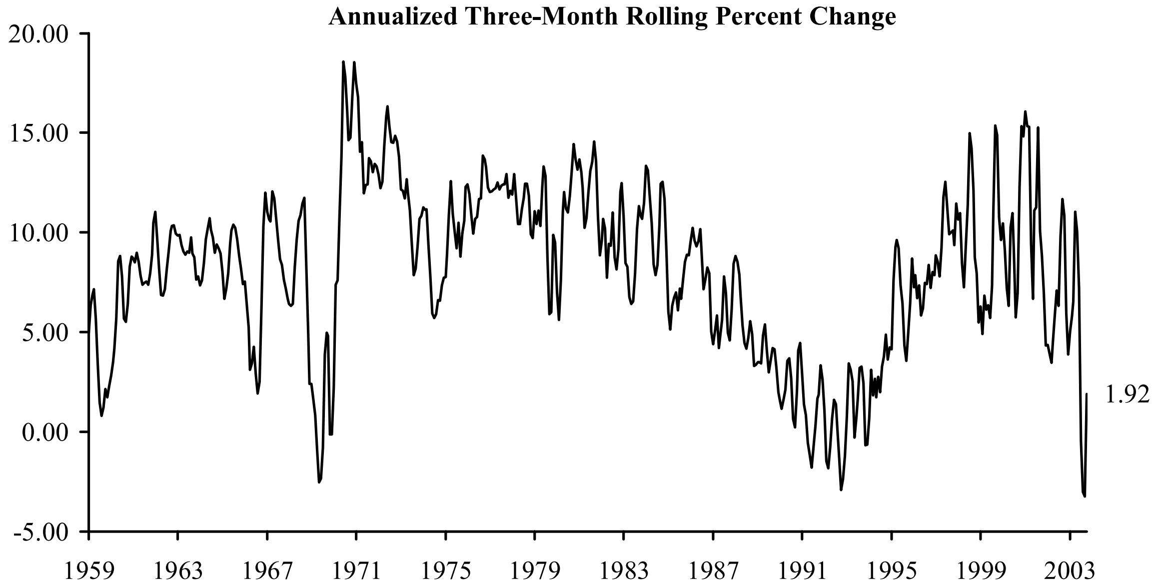
and commercial lending, coupled with large selling of Treasury and agency securities by banks over the summer, has shrunk banks' balance sheets and adversely affected the money supply. Yet another explanation is that banks have been setting aside capital in preparation for the implementation of the new Basel II capital standards. Finally, some argue the slowdown is evidence that the Fed is "pushing on a string," unable to boost the money supply because consumers and businesses are unwilling to borrow, banks are unwilling to lend, or a combination of the two.

Whatever the reason, our view is that money supply is but one data point among many, and should be treated as such. The sharp slowdown in money growth despite Herculean efforts to boost it is indeed worth watching, but as noted earlier, should not *ipso facto* be considered bearish for equity markets. Still, the longer the malaise in monetary aggregates continues, the greater the chance it will eventually have a negative impact on richly valued equity markets.

Table A

MONEY SUPPLY: M3

January 31, 1959 - January 31, 2004



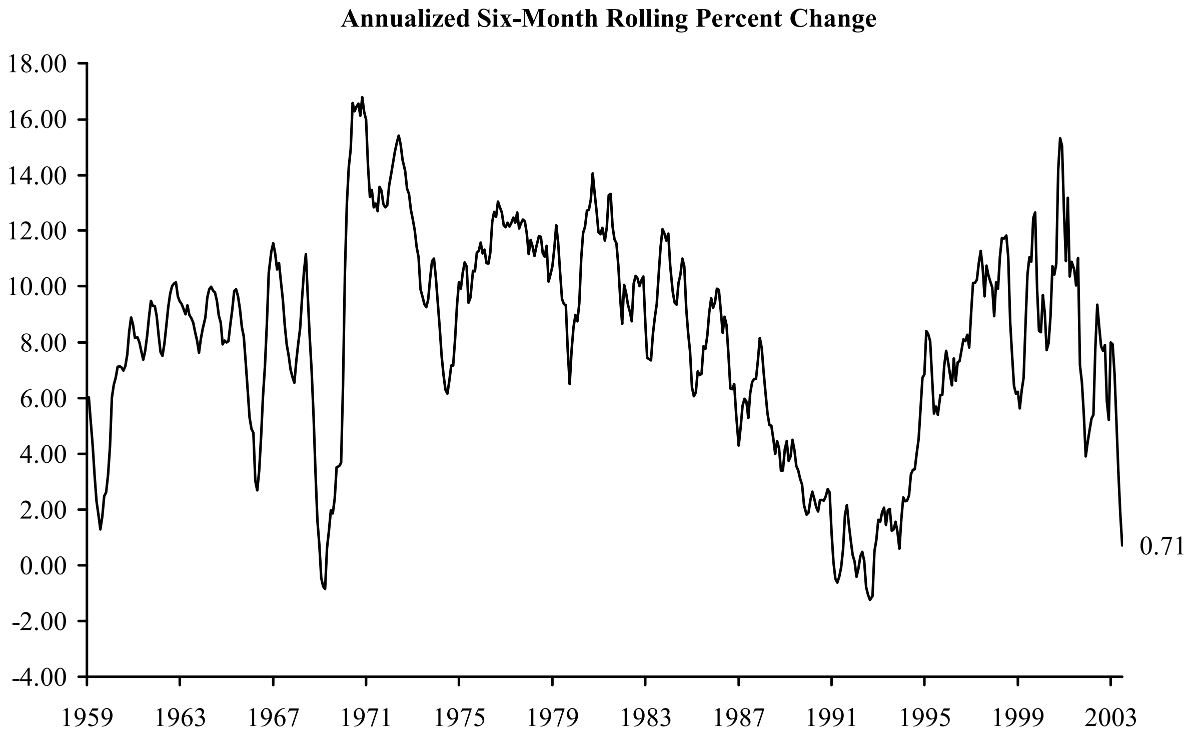
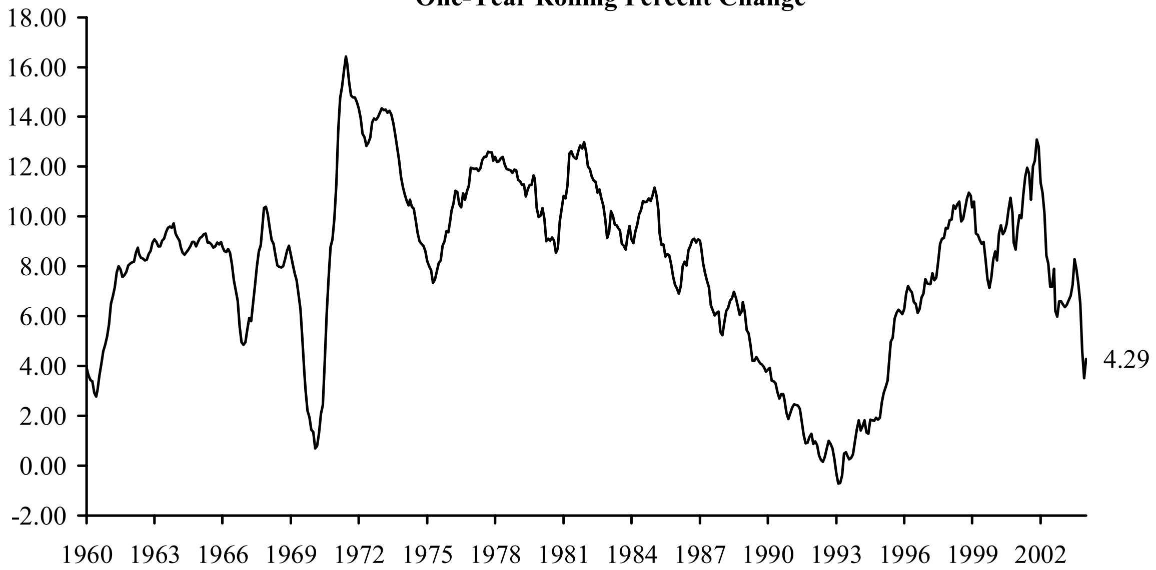
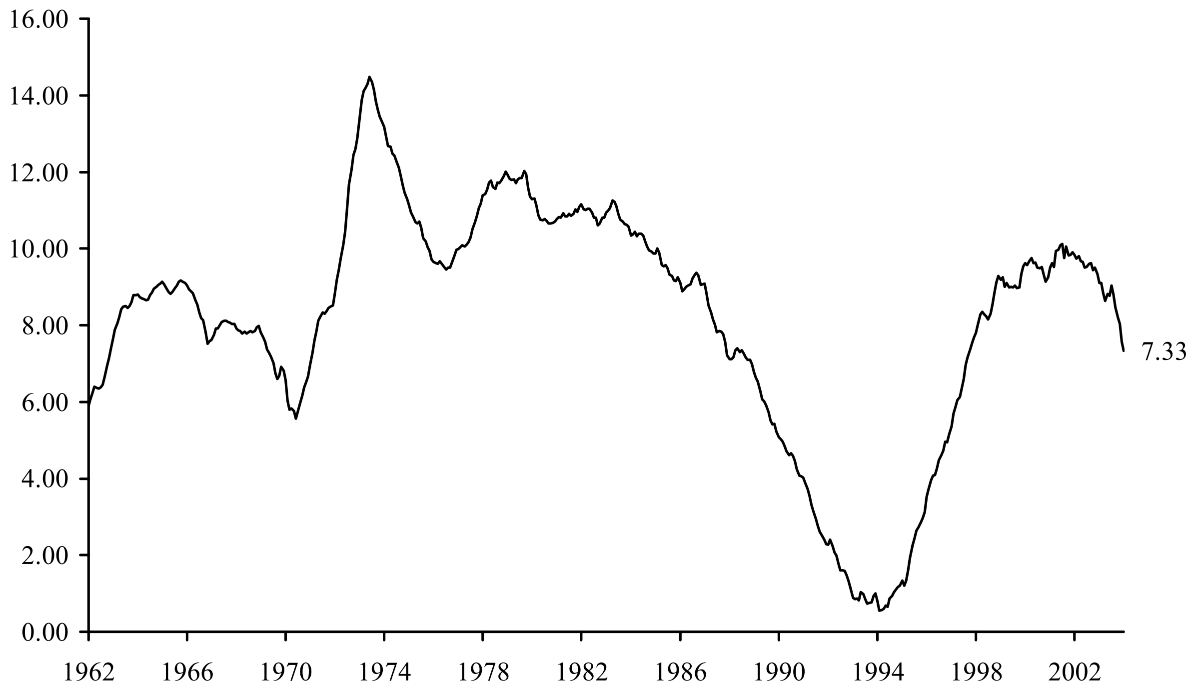


Table A (continued)

MONEY SUPPLY: M3

January 31, 1959 - January 31, 2004





Source: Thomson Datastream.