ABOUT BILL SULLIVAN

William V. Sullivan, Jr. serves as Chief Economist at JVB Financial Group, working closely with the firm's trading desk, providing analysis and commentary on the U.S. economy and the financial markets. Among his duties are authoring a weekly report on credit market trends and maintaining a regular schedule of conference calls that focus on interest rate developments. He appears frequently on Bloomberg TV and is often quoted in Barron's.

Mr. Sullivan is the familiar voice that JVB features on our weekly conference call, where he discusses the economy and the events that affect the marketplace.

He was previously associated with Morgan Stanley in New York City for more than twenty years, where he was an Executive Director and a Senior Economist in the firm's Retail Fixed Income Division. Bill published a widely quoted weekly letter on the financial markets and was a frequent guest commentator on several business networks, including Bloomberg TV, CNBC, and Fox News.

Mr. Sullivan received his Bachelor of Arts Degree in Economics from Fairfield University.

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Weekly Commentary

by Bill Sullivan, JVB Chief Economist

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M2 Growth Decelerates: Any Significance?

The M2 definition of money has experienced a dramatic deceleration in its overall growth rate during the last six months. Several factors have contributed to the marked slowdown, including a reduced level of risk aversion among investors as well as a gradual shrinkage in the size of bank balance sheets. Whether the trend will have any bearing on the economy's performance over the quarters ahead is certainly open to debate, but the pattern could ultimately represent an unexpected headwind for the recovery process.

The moderation in M2 expansion has been dramatic by past standards. In mid-February, for instance, the three month growth rate for this broader measure was pegged at 17.2%. As of August 10, 2009, the latest week for which data are available, the quarterly increase had plunged to only 2.5%, one of the slowest gains for M2 in years for a given three month period. The semi-annual pattern has also revealed a pronounced slowing. Indeed, over the six months that ended in mid-August, the M2 series was registering a 4.8% annual rate of gain, well down from the 13.4% pace observed last February. The year-over-year change is moderating as well with the current increase placed at 8.5%, off from the nearly ten percent readings that were evident as 2009 got underway.

The major influence behind the significant deceleration in M2 growth over the last half year has been the outright contractions in two key components of this series, which had previously been logging huge increases. Specifically, the small time deposit category has dropped by over $150.0 billion thus far this year, basically reversing the sizeable inflows to banks and thrifts that transpired throughout 2008. In addition, the retail money fund component has lost ground over recent months, falling by roughly $170.0 billion from last year's peak. The erosion in these categories is no doubt partly attributable to the fact that individual investors have more confidence in the stability of the financial system. In many respects, the tremendous movement of cash into time deposits and to a lesser degree money funds represented a preference for safety as households became increasingly concerned about the economic outlook. Encouraging the inflows was the expansion in deposit insurance that bolstered the sense that these assets were completely safe and free of principal volatility. To the extent that investors are now pulling funds away from small time accounts and money funds, the adjustment would seem to suggest that there is a greater willingness to take on risk, perhaps for higher earnings potential. Clearly, some of the withdrawals that have weakened the growth rate of M2 have represented a transfer of funds to equities, corporate bonds and commodities, asset classes that are not part of any definition of money.

The deceleration in M2 growth, however, may be related to developments that are less positive for the economy's general performance. In particular, the shrinkage in time deposits is definitely a by-product of sluggish loan demand. Since February, total loans on bank balance sheets have tumbled by over $270.0 billion or at a 7.4% annual rate. Nearly half of the

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decline in lending over this period has been in the commercial and industrial loan category. Consumer loans, Fed funds sales and commercial mortgages have moved lower as well since the opening quarter of 2009. The net result of these loan roll-offs is that the volume of bank assets is diminishing as the year progresses. As bank credit declines, the need to raise funds through managed liabilities such as time accounts lessens, accordingly. Effectively, banks are maintaining uncompetitive yields on their time accounts as these institutions simply don't need the cash as lending activity compresses. The low rates on these time deposits thus acts as another incentive for investors to pull their funds out of banks and seek higher yielding investments, a response that of course places downward pressure on the growth rate of the M2 definition.

Discerning the prospective economic and financial impact of the erosion in M2 expansion is far from being clear. The 17% plus annual growth rate that was evident in mid-February did precede the healing process in the capital markets as well as the apparent bottom in the equity arena that occurred just one month later. From that vantage point, the deceleration in broader money of late could be a portrayal of a reduction in liquidity that weighs against a further rally in stocks and an increased difficulty in building on the improvements that have transpired in the capital markets over recent quarters. Most worrisome, in our judgment, is the fact that the slowdown is a direct function of reduced short-term borrowing, especially by the business sector. The lack of demand for short-term credit implies that corporations are unwilling to boost working capital to support higher inventories or staffing additions, as most managements are apparently reluctant to make such commitments in a tenuous economic environment. In that regard, the moderation in M2 is a reflection of business caution that may place some limits on the economy's ability to generate a self-sustaining recovery any time soon. ■

William V. Sullivan, Jr.
Chief Economist
JVB Financial Group
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JVB Financial Group, LLC, member FINRA, SIPC
2700 N. Military Trail, Suite 200 / Boca Raton, FL 33431
(561) 416-5876 • www.jvbfinancial.com

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