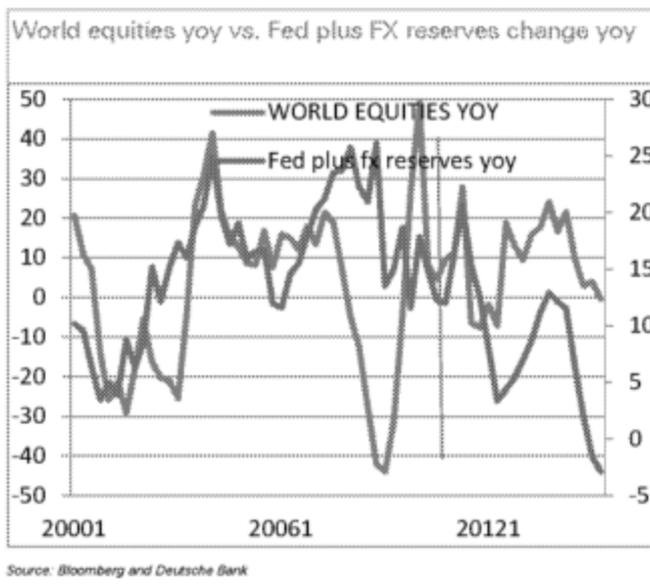
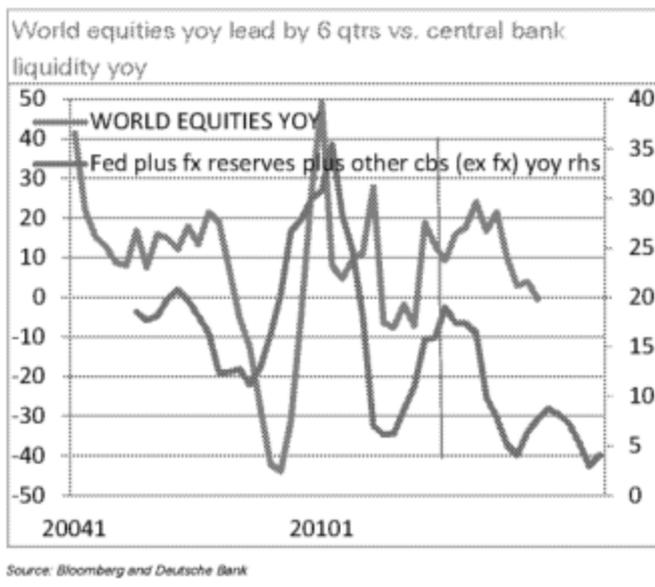




level still the same, absent Fed and FX reserve expansion, equity prices look more likely to decelerate and quite sharply. The tie out, presumably with the "leading" indicator of other central bank action is that other central banks have been instrumental in supporting equities in the past. The largest of course being the ECB and BoJ. If the Fed isn't going doing its job, it is good to know someone is willing to do the job for them, albeit there is a "lag" before they appreciate the extent of someone else's policy "failure". And just to ram home the point – this differential relationship is entirely consistent with the idea that FX reserves are accumulate don the back of Fed balance sheet expansion and so if the Fed's balance sheet is not expanding then it is a double whammy that FX reserves are also not expanding and as we shall see below are contracting!



So now let's be a little more specific on the Fed balance sheet and FX reserves now. The next chart shows both are decelerating sharply. The Fed's balance sheet is almost flat on the year and reserves are down around 5 percent and counting. The two as we have demonstrated are clearly connected. In the reverse scenario (as opposed to the above, when we demonstrated the connection when the Fed was expanding its balance sheet), tighter Fed policy forces other central banks to spend reserves to defend their currency peg and in principle shrink their balance sheets. This is the example recently with the adjustment in China's FX regime to accommodate more market based fixings. The ensuing unwind of the China carry trade has solicited what appears to have been significant FX intervention, judging by the move in front end swap spreads and dealer inventory of shorter dated Treasuries. The main point however is that it is not a change in FX regime per se that drives the loss of liquidity but that that change emanates from a tighter Fed balance sheet. Hence in the event that the Fed raises rates and we start to worry about balance sheet unwind this becomes a much more significant issue going forward. The Fed's balance sheet for example could easily be negative 5 percent this time next year, depending on how they manage the SOMA portfolio and would be associated with further FX reserve loss unless countries, including China allowed for a much weaker currency. This would be a great concern for global (central bank liquidity)

So one counter is that FX reserve loss can be offset by other central banks' liquidity injection. At one level this is tempting but flawed; at another level it is more plausible. The first level is that FX reserve loss typically is "sterilized". The shock to a country's financial system from the sudden loss of liquidity