John Dessauer Investments, Inc.

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John Dessauer's market review and update as of Wednesday January 25, 2017

Lacy Hunt, who made millions for his clients trading U.S. Treasury bonds during the devastating, high-inflation days of the 1970s, is now 74 and still successfully trading Treasury bonds. His $308 million Wasatch-Hoisington U.S. Treasury fund has outperformed over 90% of its peers in the past three and five years and returned 1.7% in 2016. When asked about his current holdings he said: "I'm still long bonds, especially the long-end, the part of the yield curve that's most sensitive to rising inflation." In other words Lacy Hunt, legendary bond trader, is doing the opposite of what others are doing. While the crowd prepares for rising inflation and higher interest rates, he sees a different future. His favorite indicator, back in the 1970s and today, is the velocity of money. The velocity of money has fallen to a record low of 1.44. For Hunt and a handful of other money velocity followers, that means that even after years of unprecedented money printing by the Federal Reserve, inflation will remain subdued and illusive. Rising inflation is the historic stock market and economic cycle killer. If Hunt is right, the stock market still has lots of room on the upside and is nowhere near as vulnerable on the downside as many believe.

Note: The velocity of money is the rate at which money circulates in the economy and is usually measured as a ratio of nominal gross domestic product (GDP) over total supply (as measured by M2).

President Trump says he intends to get the U.S. economy growing at a 3% or 4% rate this year. The International Monetary Fund (IMF) has a different opinion. Economists at the IMF believe the U.S. economy grew at a 1.6% rate last year. (We will get official U.S. government data soon.) They see the U.S. economy growing 2.3% this year, and 2.5% in 2018 - far below the Trump administration's goal and below the growth rate for the global economy. The IMF sees the global economy growing 3.4% this year and 3.6% in 2018. The question is: will faster economic growth be accompanied by an increase the velocity of money?

President Obama is the first on record not to have the economy grow at a 3% rate for at least one year during his term, and he had eight years to reach that goal. Were his policies the cause of eight years of slow growth and record low money velocity? Money velocity did decline sharply after the financial crisis and recession of 2008. However, during that time the Federal Reserve held short term interest rates near zero. According to prevailing economic theory, an aggressive monetary policy should have resulted in faster economic growth and higher inflation. Instead, unprecedented monetary policy - including Quantitative Easing (QE) and a $2.5 trillion expansion of the Federal Reserve's balance sheet - led to *de*flation rather than *in*flation. As always, the more you dig into the details, the more complicated the interaction of government policies, monetary policy and the private sector becomes. Politicians often blame the Federal Reserve for slow growth or recessions. The Federal Reserve tries to avoid taking sides in partisan political battles, but has been critical of fiscal policies during the slow recovery from the 2008 financial crisis and recession. In my view, the Federal Reserve did all it could to first prevent the recession from becoming a depression, and then kept growth as alive as it could.

Now the Federal Reserve is anxious to lift short term interest rates to what they see as a more "normal" level. Under today's economic circumstances, that probably means 2%. The Federal Reserve is not worried about inflation. They are worried about a new recession coming along while interest rates are so low. They want to be able to cut interest rates if the economy slows. For all the media talk about the prospects for faster economic growth, the reality right now and for at least the next few quarters is for more of the same – that is, growth below 3%.

Lacy Hunt's strategy of holding long term Treasury bonds will likely be a winner again. And the stock market will follow corporate sales and profits rather than be bullied by rising inflation.

There is another fact about money velocity that bears serious consideration. Money velocity peaked at 2 in 1997. The decline accelerated during the worst of the recession and its wake, but the declining trend was already long standing and entrenched before the financial crisis and recession. It was also in place before the Federal Reserve adopted its super aggressive monetary policy with near zero interest rates. When economic growth in the United States rises to 3% or more, there may be a recovery in money velocity, but it may be no more than a lift off a record low, not the start of a new trend to rising money velocity.

Jamie Dimon, CEO of JP Morgan Chase said, "They know the sausage is going to be made in taxes. It's going to take nine months, 12 months. The real detail work has to get done." In other words, it is likely to take a year before we start seeing the anticipated increase in economic growth, and longer than that before there will be conditions favoring an increase in the velocity of money.

Lacy Hunt said, “I know I’m in the minority here, I’m just trying to see the world as I think it should be seen.”

I say, thank you Lacy. It is easy to be persuaded by the political emotions and see the economy through colored glasses. It is far better to stand back and say, this is how it is right now, no matter the cause. And Lacy, I think you are right. Inflation will not become a problem for stocks or bonds until the velocity of money rises significantly. That isn’t going to be this year. Maybe not next year either. Meanwhile we remain focused on corporate sales and profits, while waiting to see if the Trump administration will follow through on promises to reform taxes and increase infrastructure spending. Fortunately, as Jamie Dimon says: “Everything looks to be pretty good with the economy right now from more jobs and rising wages, to companies flush with cash and capital markets being wide open.”

I will have the next market review and update for you one week from today on Wednesday February 1, 2017.

All the best,

John Dessauer