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John Dessauer's market review and update as of Wednesday February 1, 2017

Last week I wrote about Lacy Hunt, the velocity of money and the connection with inflation. Milton Friedman said inflation is the result of "too much money chasing too few goods." The velocity of money is a way of determining the "chasing" part of Milton Friedman's definition. Investors and the popular media focus on the "too much money" part of Milton Friedman's definition and for the last eight years have assumed that the Federal Reserve was pumping too much money into the economy. According to a report last week from Morgan Stanley the Federal Reserve's balance sheet has swollen to $4.2 trillion. That is about 22% of nominal GDP. While Milton Friedman did not specify an exact number for the "too much money" part of his definition, the unprecedented $4.2 trillion clearly is "too much money."

No wonder so many sold stocks and bonds and bought gold. They were sure inflation would rise as the Federal Reserve flooded the economy with trillions of dollars. History has proven Friedman's inflation definition to be correct. And history has provided many examples of destructive inflation following "too much money chasing too few goods." But this time it hasn't happened. On the contrary, off and on during the sluggish recovery, the economy has flirted with deflation. It's not that Milton Friedman has now been proven wrong. The reason inflation has remained tame is that the "chasing" hasn't happened. The trillions of new dollars have not been "chasing" anything. They have stayed in banks' accounts, hoarded and on the sidelines. We have seen that in the explanation for the anemic post-recession economy. Economists have told us that final

demand has been weak. That is another way of saying; the trillions of dollars are not chasing anything. Why has this time been so different? With all the new cash available why haven't businesses and consumers been borrowing and spending?

There have been lots of excuses from politicians for the anemic growth the last eight years. I am sure changing demographics and other factors are part of the truth. But, it is also likely that government policies have played a role in subduing the rate of economic growth. President Trump is already making changes. Odds are he will succeed in reversing at least some of the inhibiting and overbearing regulations imposed by the Obama administration. Some economists are already warning that success increasing the rate of growth will mean higher inflation. They are Trump critics who have lost sight of the Federal Reserve's new tools.

All those economists who expect an outburst of high inflation and high interest rates when growth accelerates are in for a disappointment.

First of all the economy is still struggling. President Trump's goal of 4% growth this year is unrealistic. The economy limped along at a 1.9% annual rate in the final quarter of last year. For all of 2016 the U.S. economy grew 1.6%, the slowest pace since 2011 and down from 2.6% in 2015. The Congressional Budget Office (CBO) and economists at the International Monetary Fund (IM) expect the economy to expand at a 2.3% rate this year. That is a real improvement over 2016, but far short of the 4% Presidential goal.

It is going to take time to design and implement tax and health care reforms. And it will take more time for the economy to adapt and adjust after the reforms are

implemented. The President and his administration will be fortunate if growth approaches 3%-3.5% by 2018.

Slow growth has been a major companion of the low velocity of money. The two go together. It will take sustained growth above 3% before the velocity of money rises much above today's record low. That alone says inflation will stay low this year and next.

The first thing economists and investors think of when it comes to fighting inflation is high interest rates. The reason central banks raise interest rates to slow the velocity of money. High interest rates make holding cash attractive and make borrowing expensive. They attack the "chasing" part of Milton Friedman's definition by raising interest rates. This time the Federal Reserve has a new, powerful tool, its swollen balance sheet. The Federal Reserve can hit inflation where it hurts the most in the "too much money" part. According to Morgan Stanley in 2018 the Federal Reserve will no longer reinvest cash received from maturing mortgage backed securities. Allowing securities to mature has the same effect as selling securities. It takes money out of the system. Should the Trump administration be more successful than now expected, the Federal Reserve can start selling securities and accelerate the contraction in the balance sheet and money supply. With $4.2 trillion available, the Federal Reserve is in an extremely strong position to counter inflation, perhaps stronger than at any time in many decades.

The bottom line is that inflation is not currently an issue for investors and is not likely to become an issue for a long time.

Likewise, interest rates are not likely to become a prime anti-inflation tool for a long time. The Federal Reserve pushed interest rates to near zero while battling the downward pull of the recession. Now the Federal Reserve wants to "normalize" interest

rates. This is not to fight inflation. It's the opposite, preparation in case the economy falters. Once satisfied that interest rates are back to "normal" the Federal Reserve is likely to keep interest rates stable even as the economy gains strength. Shrinking the swollen balance sheet by selling securities will be the number one anti-inflation tool, possibly for several years.

The Dow Jones Industrial Average rose above 20,000 and then stalled. Stocks are now showing mixed results, responding to fundamentals. Earnings are generally coming in better than expected with many showing renewed growth in sales and profits. The evidence is growing that the earnings recession is over and that a new cycle of growth in sales and earnings is beginning. Never-the-less in the short term, stocks are likely to pull back after the recent surge to record highs.

I will have the next market review and update for you one week from today on Wednesday February 8, 2017.

All the best,

John Dessauer

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