First Trust
Monday Morning OUTLOOK
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Velocity May Be Picking Up

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One of the reasons the current economic expansion has been a Plow Horse rather than a Race Horse is the lack of monetary velocity, which is how fast money circulates through the economy.

Velocity has been slow for a lot of reasons, including banks rebuilding capital after 2008-09, Dodd-Frank, and the Federal Reserve paying interest on bank reserves, a new policy it started in 2008. Another key reason is that banks have operated as if they assume the huge expansion in the Fed's balance sheet will eventually be retracted, so why lend it out?

But it's starting to look like velocity is reviving. In the past year, "core" consumer prices, which exclude food and energy, are up 2.2%, versus a 1.6% gain in the twelve months ending January 2015. Yes, the overall CPI is up only 1.3% in the past year, but these prices were actually down 0.2% in the year that ended January 2015. Moreover, oil prices are not going to fall forever. Once they stop falling – and there are signs that we are at or near the bottom already – inflation for overall consumer prices will accelerate as well.

Meanwhile, core producer prices were up 0.4% in January, the largest increase for any month in more than a year. Put this together with consumer price data and continued Plow Horse real economic growth, and it's consistent with an acceleration in nominal GDP growth (real GDP growth plus inflation). That's significant because nominal GDP growth has been oddly tame recently, up only 3.4% annualized in the past two years, versus 3.6% in 2012-13 and 4.1% in 2010-11.

Yes, we've had temporary accelerations of inflation before, earlier in the expansion, but what makes it different this time, what signals that it's more likely to persist is the acceleration in wages as well. In the past six months average hourly earnings are up at a 2.9% annual rate, the fastest pace for any six-month period since the expansion started.

In addition, the growth in the M2 measure of money – mostly currency, deposits in checking accounts, and savings accounts – increased at an 8.2% annual rate in the past three months, the fastest pace since the end of QE3 back in 2014.

Although velocity has shown signs before of accelerating, we think this time it's for real. It looks increasingly likely that the Fed is going to significantly delay rate hikes. It might not raise rates again until June or maybe even December again, just like last year. In turn, that sends banks a signal that the Fed isn't going to reduce the size of its balance sheet anytime soon. Instead, it's more likely the Fed will just let time do their work for them, keeping the balance sheet enlarged and letting natural growth in the economy very gradually reduce the balance sheet relative to GDP.

All of this is yet another reason why the recent selloff in US equities is likely to be temporary and there's likely to be a major correction in Treasury bond prices ahead, with yields rebounding higher for the rest of the year.

In addition, as central banks in Europe and Japan continue to experiment with negative interest rates, the US dollar may weaken as negative rates abroad lead to financial compression among foreign financial institutions and increase the appetite of Europeans and the Japanese to hold raw cash balances rather than put their money in banks.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
2-23 / 9:00 am	Existing Home Sales – Jan	5.330 Mil	**5.360 Mil**		5.460 Mil
9:00 am	Consumer Confidence – Feb	97.1	**97.3**		98.1
2-24 / 9:00 am	New Home Sales – Jan	0.520 Mil	**0.527 Mil**		0.544 Mil
2-25 / 7:30 am	Initial Claims – Feb 21	270K	**271K**		262K
7:30 am	Durable Goods – Jan	+2.6%	**+5.0%**		-5.0%
7:30 am	Durable Goods (Ex-Trans) – Jan	+0.2%	**0.0%**		-1.0%
2-26 / 7:30 am	Q4 GDP Second Report	0.4%	**0.4%**		0.7%
7:30 am	Q4 GDP Chain Price Index	0.8%	**0.8%**		0.8%
7:30 am	Personal Income – Jan	+0.4%	**+0.5%**		+0.3%
7:30 am	Personal Spending – Jan	+0.3%	**+0.3%**		0.0%
9:00 am	U. Mich Consumer Sentiment- Feb	91.0	**91.0**		90.7