Case Study on Inflation vs the Velocity of Money

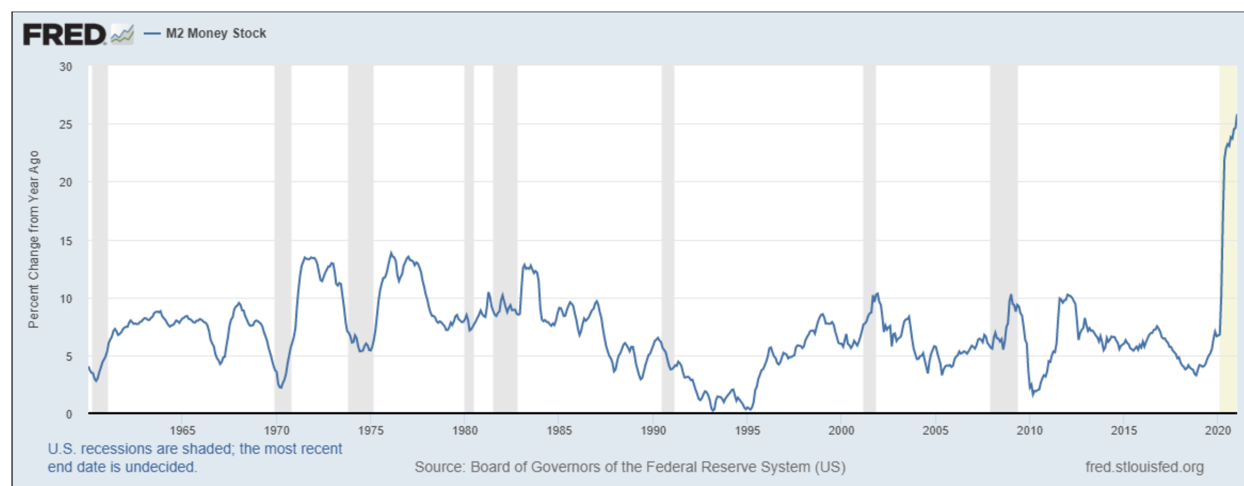
The question many investors are asking is, given this increase in money supply, is a period of higher inflation upon us? While we at Avenue believe higher inflation is likely this year, we will soon revert back to an economy with low growth and low consumer price inflation.

Velocity of money is an esoteric economic term that we have mentioned in past letters at the risk of being too technical and quite frankly, pretentious. At Avenue we are always attempting to write about investing in as clear and understandable a language as possible. However, velocity of money is now an extremely important concept to grasp, and we feel most investors are missing it. One cannot understand where economic growth and inflation are going without understanding the historic decline in the velocity of money.

Velocity of money is described by the Equation of Exchange which economic students bump into in university level macroeconomics then promptly forget. It just has not been relevant until this last decade. Many classical economists believed it was a constant and something you could disregard. And this was the case for most the 20th century.

The Equation of Exchange : GDP = Money Supply x Velocity of Money.

The concept is that the value of a country's Gross Domestic Production is simply a function of how much money is in the economy multiplied by how fast that money circulates between people and businesses. We can see that the money supply has increased through 2020. But is this inflationary?



What is clearly revealed by calculating the velocity of money is that for every increase in the money supply there has been a commensurate decrease in the velocity of money. The money in the economy is circulating at a decelerating rate. There are all sorts of reasons for this. The main one being that there is just too much debt in our modern economy. But the conclusion is the same, it is really hard to get any lasting inflation if we can't get the velocity or the speed with which money changes hands to increase. Velocity can only come from making productive investments that generate an income stream to pay back both principal and interest, or from a complete loss of faith in a currency.

While we will have a temporary increase in inflation as the economy recovers from the pandemic, we believe inflation will return to the 1 to 2% level over the next few years. Therefore, bond yields will remain low, and the stock market multiple will remain high by historical comparisons.