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7th October 2008
No.282

The politics of MV

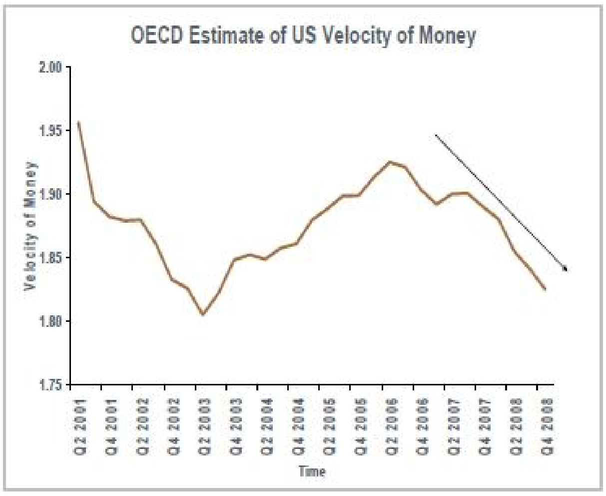
Global fixed income strategy: overweight duration in Western bond markets, underweight the US dollar

We don't seem to know very much for certain right now (except that we aren't allowed to use the phrase 'bail out' because it has too many negative connotations and that we must substitute the much nicer "rescue plan"). But the one thing we do seem to agree on is that the bail out of the US banking system will increase the amount of money in the system. This is the well-worn idea that the US Federal Reserve goes down into the basement and turns on the metaphorical and physical printing presses, thereby flooding the world with US dollars.

Under normal circumstances you would expect this would do bad things to the US dollar, inflation and bond yields. But circumstances are anything but normal and in recent weeks we have seen the US dollar rise, inflation expectations fall and nominal bond yields decline to all-time lows. To think it through you have to go back to school and have a look at the equation: **MV = PQ Money x Velocity of Money = Price (Inflation) x Quantity (GDP)**

Now the problem here is that the Velocity of Money (i.e. how quickly it circulates around the economy as a result of the same dollar, pound, euro or whatever simply being lent) has fallen, to all intents and purposes, to zero (because the interbank markets have seized up). So, no matter how much money you pump into the system, it just doesn't show up in prices or GDP and you have a deflationary recession on your hands. If you listen to some of the voices in the markets then, effectively, this is where we are right now in the US. As can be seen in the chart (above right), there is evidence to show that the ideas surrounding money velocity aren't merely hypothetical ¨C they are real. In portfolio terms you would want a long duration bond strategy as yields fell.

At the same time you would have thought that this situation would be bad for the US dollar. But the complication here, as things stand, is that, in the absence of US dollars from the system (they are going into US T-bills yielding an annualised 0.2% for instance), the greenback is actually rising against the euro despite all of the efforts of European central banks to make US dollars available. Put simply, there aren't enough of them because they are being hoarded.



This is all very perplexing as the interaction between the four elements of the MV=PQ equation are clearly not simple and not linear. In fact, the combinations and possibilities are so manifold that we have summarised them below in a scheme that had the unifying idea that money will be and is being made available through the Emergency Economic Stability Bill ('EESB', formerly known as the Troubled Asset Relief Programme or 'TARP') in the US as indicated by three arrows pointing skywards (¡ü¡ü¡ü). All other variables are similarly indicated to be falling (¡ý), rising (¡ü), or going sideways (¡ú). There is also an indication of the effect on bond yields and the dollar as well as the necessary portfolio position to take advantage of the market movements.

Phase	*M*	*V*	*P*	*Q*	*Economics*	*Yields*	*US Dollar Direction*	*Portfolio Duration Position*	*Portfolio USD position*	*Comment*
1 (Now)	↑↑↑	↓↓↓	↓↓↓	↓↓↓	Thoughts of a deflationary depression	Falling	Rising	Long	Long	No US dollars in the system; locked in US T-bills
2	↑↑↑	→	→	→	Bottoming of the cycle; velocity of money stabilises	Stable	Falling	Neutral	Short	US dollars come out of US T-bills and move around the system and into other currencies.
3	↑↑↑	↑↑	↑	↑	Government intervention continues; money velocity picks up	Rising	Rising	Short	Long	EESB plan begins to work; US starts recovery before other economies
4	↑↑↑	↑↑↑	↑↑↑	↑↑↑	Government intervention continues and the velocity of money accelerates as banking system functions normally again	Rising	Falling	Short	Short	EESB plan saves the world, growth and inflation breaks out everywhere but global risk-management sees international investors spreading risks more widely

Obviously, writing out such schemes leaves you open to a flood of alternative proposals, but this one appears to make some sense given the evidence we have to hand. But, as shown above, OECD estimates confirm that the velocity of money is declining and, now Congress has voted in favour of the EESB, money supply should expand rapidly. In that case the US Federal Reserve (and the European Central Bank and Bank of England) should cut interest rates to exhaust the monetary options and allow the money from government interventions to enter the banking system (even if it is just to stabilise the situation). How this happens, only history will tell us, but for sure that is what will need to happen and, in terms of the present scheme, we will move from phase 1 to phase 2.

The true transition from phase 1 to phase 2 (we are probably in between phases right now) will only occur when the chronic US dollar shortage in the system is relieved, which is the only reason why the US currency is currently appreciating in such an exaggerated and irrational way. Once any sense of relief is established, then (and only then) will the US dollar stop rising. In fact when the US dollar starts to fall again then we will know that the lubrication being applied by the central banks is actually beginning to have an effect. When this starts is anyonefs guess, but when it starts, the fall in the US dollar should be as fast as (if not faster than) its appreciation we have seen since 7th August when it broke out of the range which has been established since mid-February.