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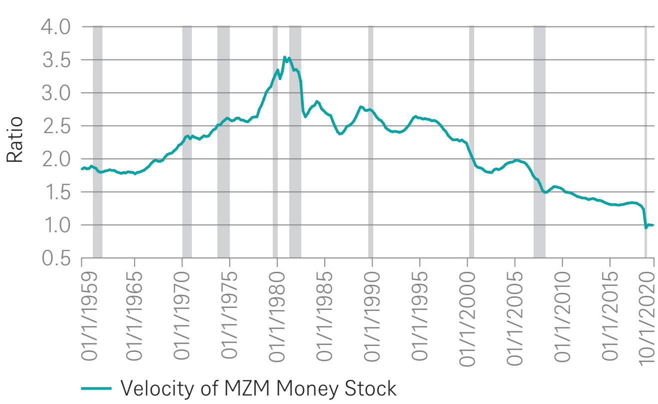
The link between money velocity and speculation

The prices of financial assets are set by supply and demand. If money velocity is very high, it means a relatively high amount of money is going into the real economy, and the public does not have as much left over for savings. That means the demand for financial assets will be relatively weak. In contrast, when money velocity is very low and demand for financial assets is high, speculation usually emerges.

The graph below, from the website of the St Louis branch of the Federal Reserve Board, shows money velocity in the United States since 1959.

An observer will quickly notice that money velocity peaked around 1981-1982 and hit its low point on the chart in 2020 during the pandemic. As a quick refresher, money velocity is the V in the equation MV = PY [money x velocity = price level x real output], describing how much of the money supply is getting into the real economy, GDP.

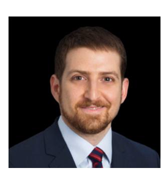
FRED GRAPH OBSERVATIONS



Source: St. Louis Fed (Federal Reserve Bank of St. Louis Velocity of MZM Money Stock (DISCONTINUED) (MZMV) | FRED | St. Louis Fed (stlouisfed.org)

1981-1982 represented a secular low in financial asset valuations. Both stocks and bonds were extremely cheap. The S&P 500 Index traded at a single digit price-to-earnings multiple. U.S. Treasury bonds had yields in the mid-teens. This was not a coincidence. The prices of financial assets are set by the supply and demand for financial assets. If money velocity is very high, it means a relatively high amount of money is going into the real economy, and the public does not have as much left over for savings. That means the demand for financial assets will be relatively weak. If there is weak demand for financial assets, financial asset valuations will be low.

We saw the opposite in 2020. Both stocks and bonds were extremely expensive. Money velocity had been falling for almost 40 years, but really took a sharp leg down during the Covid-19 pandemic. This is, of course, because large segments of the real economy were closed, and money was literally not able to get into it even if it wanted to. As a result a lot of money supply was left over to be put into savings, which is a big reason why the stock market recovery from March 2020 was so strong. Demand for financial assets was high.



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But when demand for financial assets is very high, and investors can clearly see that valuations of traditional savings vehicles are already richly priced, speculation usually emerges. Investors have money burning a hole in their pockets and are looking for something to do with it. Savvy charlatans and con artists are able to convince the public to put their excess savings into investments that would ordinarily be considered extremely risky. Thus, it is no coincidence that during 2020 we started hearing a lot more about all sorts of different forms of speculation, from new cryptocurrencies to sports betting to Robin Hood. One of my favorite quotes, attributed to Charlie Munger, is that when seeing a new phenomenon, rather than ask about the phenomenon itself, investors should ask themselves, “Why am I seeing this now?” In the case of speculation, investors should be asking themselves, “Why am I seeing all these signs of speculation now?” The reason is because money velocity is low.

So why am I, a small cap equities portfolio manager, writing about this topic? Well, it’s because it explains a lot about what has been going on with small cap market leadership recently. In the years leading up to 2020, speculative stocks (no earnings, often no revenue, sometimes no product) had been doing unusually well compared to how these types of stocks have performed historically. Moreover, they seemed to have no problem raising as much equity or debt as they wished, regardless of how likely they were to be able to pay it back. However, once the pandemic hit, they started doing even better, by a lot! They finally peaked out around late summer/early fall of 2020, at which point more economically cyclical stocks finally started to outperform. The timing was no coincidence as it was around this time that the market started to anticipate that vaccines were likely to work and the real economy could perhaps re-open in 2021.

I anticipate that this cycle will continue for at least a few years. 2020 was such an exceptional time in that large areas of the economy were closed for so long, that it likely marked at least a cyclical trough for money velocity. However, there is good reason to believe that it may have actually represented a secular trough in money velocity as well. That is a topic best addressed in another paper, but I will simply tease it by saying that one of the major drivers of money velocity on a secular basis is wealth inequality. Because the wealthy save a disproportionately high percentage of their money relative to the poor, money velocity tends to be high during periods of relatively low wealth inequality, and low during periods of relatively high wealth inequality. The 40 year drop in money velocity from 1980 to 2020 was a result of the 40 year increase in wealth inequality. Because I believe wealth inequality has likely peaked and will reverse from here (again, I can elaborate in a different paper), I believe money velocity has troughed on a secular basis.

Over the years, as money velocity has fallen, speculative stocks have come to comprise a larger and larger percentage of the small cap indices. This is, of course, because these indices are purely passive and have no valuation discipline. Stocks with no earnings and no revenue are at record high percentages of the Russell 2000. Amazingly, a friend pointed out to me recently that the two largest holdings in the Russell 2000 Value index were Gamestop and AMC Entertainment!

This is why I am so bullish on the prospects for active managers to outperform within the small cap space over the next decade. As money velocity rises off its secular trough, the headwinds for speculative stocks will only increase. With the passive indices unable to sell these names because of their rules-based methodology, active managers will be shooting fish in a barrel.

Glossary

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

The Russell 2000 Value Index tracks small-cap value domestic stocks. Value stocks have lower price-to-book ratios and lower forecasted growth values. It is not possible to invest directly in an index.

The S&P 500 Index tracks the performance of 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization. It is not possible to invest directly in an index.

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