Daiwa's View

What positive Marshallian K means

➢ Change in market phase

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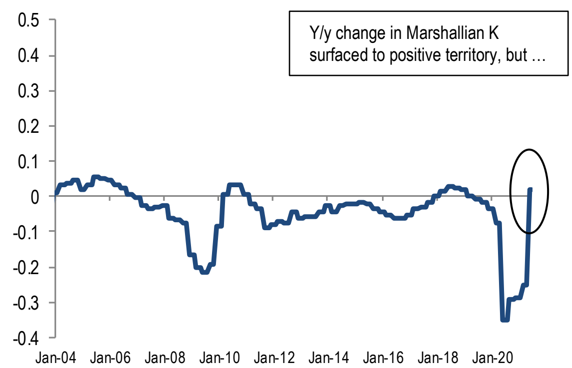
Change in market phase

The ratio of nominal GDP and money supply (M2)—Marshallian K or velocity of money—is an interesting topic that we have occasionally touched on in *Daiwa's View* reports in the past. Recently, this topic has again garnered attention in the market with the growth rate of 2Q US nominal GDP exceeding that of M2. Therefore, we are posting an update on current thinking.

Firstly, I feel it is wrong to view the recent development in which Marshallian K turned positive as a sign of a collapse. However, as this is a phenomenon that indicates a change in market phase, we think the impact both on risk assets and interest rates should be watched carefully.

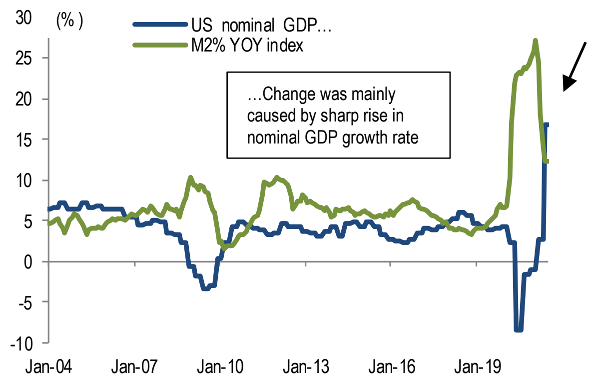
Why is this not a sign of a collapse? Because, primarily, the +16.7% growth rate of 2Q US nominal GDP is an extreme figure that is temporary in nature, reflecting pent-up demand and President Biden's fiscal expenditures amid the COVID-19 pandemic. Undoubtedly, the growth rate of nominal GDP exceeded that of M2 (which averaged 14.7% during Apr-Jun), but we should consider the special nature of the nominal GDP in this case. Also, the recent sharp drop in the growth rate of M2 is partially related to the balance of the Fed's reverse repo operations, but this is just passive absorption of excess liquidity. It is somewhat unreasonable to liken the current situation to the phase before the collapse in 2018 when the Fed was implementing quantitative tightening.

Marshallian K (M2, y/y ppt)



Source: Bloomberg; compiled by Daiwa Securities.

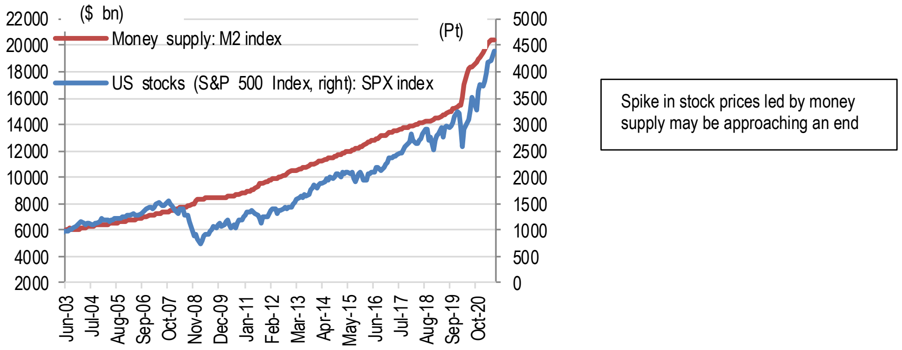
Nominal GDP Growth Rate, M2 (y/y annualized)



Source: Bloomberg; compiled by Daiwa Securities.

That said, the Fed is expected to decide on tapering within the year (albeit not quantitative tightening), and additional supplies of excess liquidity are likely to be suspended. Since the outbreak of the pandemic, US stocks have soared in line with the surge in M2, instead of profits (approximately equal to nominal GDP). However, the spike in stock prices led by money supply, like this, is probably approaching an end. Eventually, we may look back on the current development of Marshallian K turning positive as a milestone in the market.

US Money Supply (M2), **US Stocks** (S&P 500 Index)



Source: Bloomberg; compiled by Daiwa Securities.

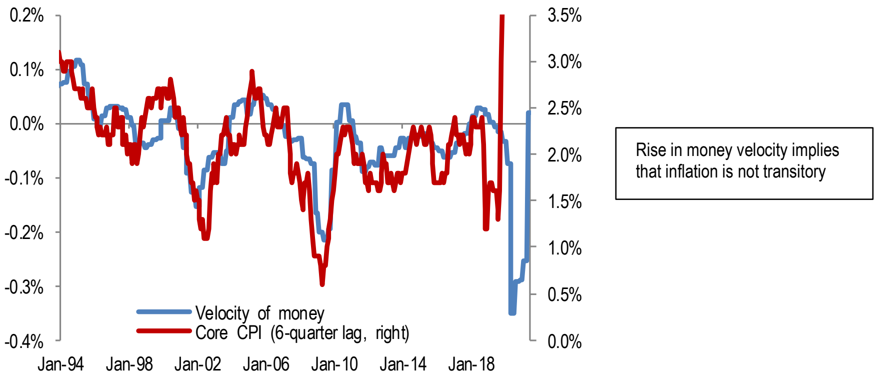
- Impact on inflation
  We mustn't overlook the impact on the inflation rate or the Fed's stance.

To reconfirm, the growth rate of nominal GDP exceeding that of money supply means a rise in velocity of money. As explained in past reports, a change in money turnover tends to be observed ahead of core CPI in the US.

In fact, around August 2020, people thought that a decline in money velocity implied a disinflation shock. Considered in this context, it can be said that the current reversal of money velocity implies a rise in the inflation rate.

This means the possibility of a rise in inflation based on long-term correlations with macro variables, instead of a transitory rise. Given the cautious stance against inflation risk indicated in the June FOMC meeting, as well, we can say that the rationale behind the Fed's move towards an exit strategy has been further reinforced.

US Core CPI, Money Velocity



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