

Velocity, Uncertainty & the Economy

Recently we lifted our recession odds to 25% from 10%. For some, this was worrisome. In recent weeks we've been asked, "If you guys get a little bearish on the economy, after being bullish for so long, shouldn't I get really nervous?" Our answer to this question is "no."

Our base case (75%) is the economy continues to grow. Not gangbuster growth; more plow horse data, such as the 2% real GDP growth for Q3 and what we expect to be a workmanlike 120,000 increase in payrolls for October.

We were focused on the potential for a drop in velocity – the turnover rate of the money supply. To put this in plain English, the M1 money supply (cash and checking accounts) stands at \$2.4 trillion; M2 (M1 plus savings deposits, short-term time deposits, and retail money market funds), is \$10.1 trillion. And, in the past year, total spending in the economy (nominal GDP) has been \$15.5 trillion.

Velocity measures how often each dollar is spent. Dividing GDP by M1 shows that every dollar of M1 is spent 6.6 times while every dollar of M2 is spent 1.5 times. Both are down significantly in recent years (and even in recent quarters), partly because of quantitative easing which has artificially boosted M1 and M2 without any kick to GDP growth.

Milton Friedman postulated that velocity was either stable or grew at a stable rate. However, a panic – like the US had in

2008/2009 – obviously can cause a decline. And it is also apparent that quantitative easing, which boosts excess reserves held at the Fed, can also lead to a decline in the amount of GDP supported by a certain amount of money.

Despite the recent decline in velocity, the economy should continue to grow. Productivity and wealth gains from new technology (the cloud, smartphones, tablets, fracking,...etc.) are pulling the economy along against the headwinds of excessive government spending and regulation. The economy is growing slowly, not because of the recent financial crisis, but because of policy mistakes from Washington, DC.

Nonetheless, uncertainty has reached a crescendo. The election coming in just 8 days and the "Fiscal Cliff" at year end have created an environment that tilts measures of risk and reward for business leaders. The results include weak industrial production, new orders, and business investment. While we don't expect this to lead to a recession, with velocity in play and uncertainty so high, the risks are real.

So far, weaker business investment is being offset by a stronger housing market, which means the economy is likely to avoid any dip in activity. We anticipate that the pullback in business activity will be reversed once the fog of uncertainty clears. Look for stronger growth in 2013.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
10-29 / 7:30 am	Personal Income – Sep	+0.4%	+0.3%	+0.4%	+0.1%
7:30 am	Personal Spending – Sep	+0.6%	+0.7%	+0.8%	+0.5%
10-30 / 9:00 am	Consumer Confidence – Oct	73.0	75.0		70.3
10-31 / 8:45 am	Chicago PMI – Oct	51.0	51.8		49.7
11-1 / 7:30 am	Q3 Non-Farm Productivity	+1.5%	+2.1%		2.2%
7:30 am	Q3 Unit Labor Costs	+1.0%	-0.5%		+1.5%
7:30 am	Initial Claims – Oct 27	370K	368K		369K
9:00 am	ISM Index – Oct	51.2	51.4		51.5
9:00 am	Construction Spending – Sep	+0.7%	+0.7%		-0.6%
<i>Afternoon</i>	Domestic Car/Truck Sales – Oct	11.5 Mil	11.5 Mil		11.3 Mil
11-2 / 7:30 am	Non-Farm Payrolls – Oct	125K	120K		114K
7:30 am	Private Payrolls – Oct	125K	120K		104K
7:30 am	Manufacturing Payrolls – Oct	-2K	-5K		-16K
7:30 am	Unemployment Rate – Oct	7.9%	7.8%		7.8%
7:30 am	Average Weekly Earnings – Oct	+0.2%	+0.2%		+0.3%
7:30 am	Average Weekly Hours - Oct	34.5	34.5		34.5
9:00 am	Factory Orders – Sep	+4.6%	+4.9%		-5.2%