

DAILY GLOBAL
COMMENTARY

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Shape of the Recovery – “V” or “U”

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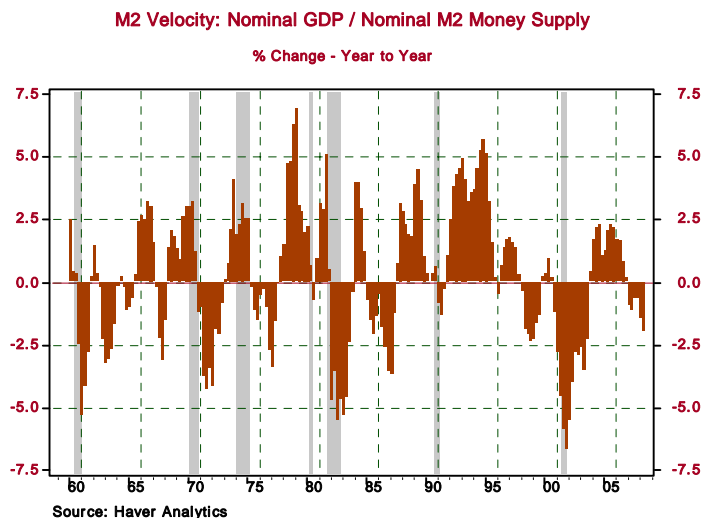
Years ago there was an equity strategist at Bache-Halsey (I said it was years ago) who almost always got it wrong. When he finally was forced to leave “to pursue other interests,” clients were furious. The guy was a near-perfect negative indicator. When he said buy, it usually paid off to sell.

You know where this is going. A certain “economist” is forecasting a “V”-shaped economic and stock-market recovery based on a forecast of a “V”-shaped recovery in monetary velocity.

The definition of monetary velocity is nominal GDP divided by the nominal supply of money. Monetary velocity is another way of describing the public’s demand *to hold* money. Rising monetary velocity implies that the public’s demand for money balances is falling and *vice versa*.

Chart 1 below shows the year-over-year historical behavior of monetary velocity in terms of the M2 money. The shaded areas are periods of recession. Notice that the change in velocity tends to *contract* in the early quarters of business recoveries. In 1992, a year *after* the economic recovery commenced in the second quarter of 1991, velocity did grow relatively rapidly in what was termed the “jobless recovery.” **In general, then, history is not on the side of a sharp rebound in monetary velocity anytime soon.**

Chart 1



Economic theory also is not on the side of a quick turnaround in monetary velocity. Chart 2 shows the history of household deposits and money fund shares as a percent of household net worth (wealth). From the first quarter of 1952 through the second quarter of 2008, the median percentage of household deposits and money fund shares to household net worth has been 14.4%. In the second quarter of 2008, the percentage was 13.3, more than 100 basis points below the

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median. With the recent volatility and declines in the stock market, with declining home values, with slowing inflation and with the collapse in inflation expectations (see Chart 3), it would seem reasonable that households might want to increase their relative holdings of an asset that is redeemable at par (now that the amount of an FDIC-insured bank account has been increased and federal insurance of money fund balances has been authorized.)

Chart 2

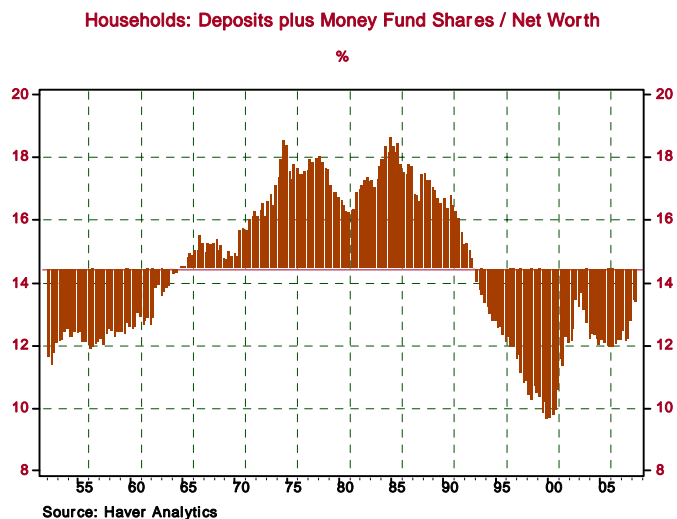
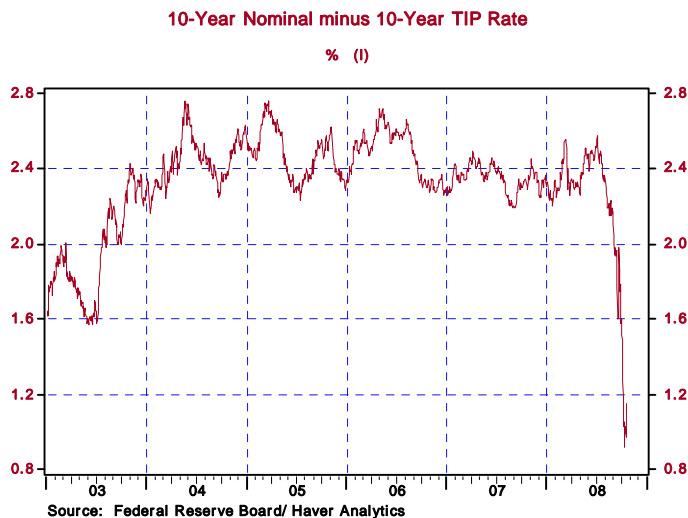


Chart 3

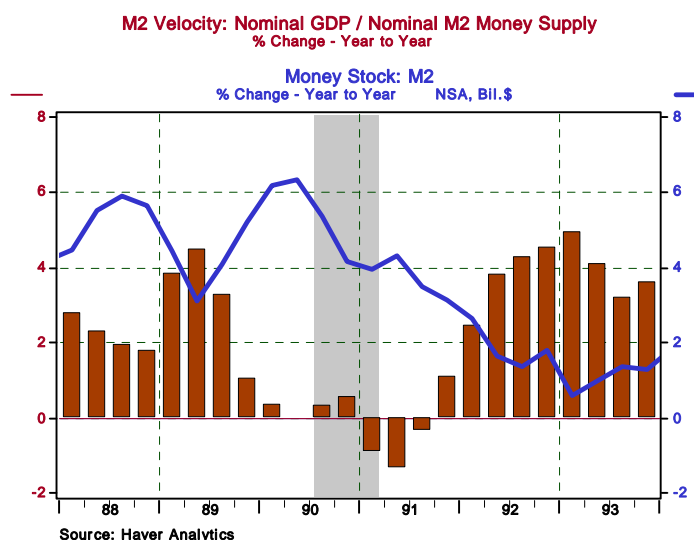


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Of course, any money and banking student knows, even if the anonymous erroneous “economist” might not, that velocity is only one component of the GDP identity. Another component is the *amount* of money created. And any money and banking student knows – at least any of my past students – that the supply of money depends on the growth in earning assets (loans and investments) of depository institutions. With banks suffering from “capital inadequacy” these days, it is unlikely that their earning assets will be growing rapidly anytime soon. *Ergo*, the supply of money is unlikely to grow rapidly anytime soon. (It has in the past couple of weeks, but this appears to be an aberration.)

I want to return to a discussion of the “jobless recovery” of 1992. Chart 4 shows the year-over-year change in M2 velocity as well as the year-over-year change in the M2 money supply itself. Notice that as M2 velocity growth picked up, M2 growth was *decelerating* to what was a very low rate. If you recall, the early 1990s were years when banks suffered from severe “capital inadequacy” that restricted their lending to the private sector.

Chart 4



In sum, both history and theory do not suggest a near-term surge in monetary velocity. Moreover, theory suggests very sluggish growth in the broad money supply. As a result, the odds of a “V”-shaped economic recovery are low. But even a blind pig finds an acorn once in awhile. So, there is some finite probability that the aforementioned anonymous “economist” might be right this time. It would be a shame, however, if he or she were right. Then his or her worth as a reliable negative indicator would be diminished.

As an aside, if you can guess the name of the anonymous “economist,” you will win a lifetime free subscription to the “Daily Global Economic Commentary.”

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