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First Trust

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Monday Morning Outlook

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# We Are the Catalyst

Many observers are pessimistic about the economy because they believe a vicious downward cycle has taken hold, where less spending leads to fewer jobs, which reduces purchasing power, leading to even more job losses. Many just can't see how this vicious cycle will stop.

We are frequently asked; "what is the 'catalyst' for a recovery?" What force (external or internal) will break the downward cycle of job losses? How does it ever end?

Taking this thought process to its conclusion clearly shows that something is missing. If job losses beget less spending and more job losses, then recessions would never end. On the other hand, if job gains beget more spending and more job gains, then expansions would never end.

But, a cursory look at history shows that this can't be true. Since 1854, the US economy has gone through 32 business cycles (recessions and recoveries). In other words, the direction of economic activity eventually changed. Many times in these past cycles, the economy started to recover well before employment turned up.

There are a number of reasons for why this is true. The first reason is that the combined decisions we make as independent members of a free society tend to generate economic growth. When people lose their jobs, it does not mean they lose their *ability* to be productive. It may take time for them to find a new position that matches their skill set, but as long as they have worthwhile abilities, they will eventually get another chance to produce.

In the meantime, companies can use layoffs to increase efficiency, laying the groundwork for future increases in profits and wages for their remaining workers. What that means is that a 1% loss in jobs results in a smaller than 1% loss of production. And using assets more productively frees up resources to do "new" things. We have lost millions of farming jobs over the decades and centuries, but the nation as a whole is more prosperous as a result, not less.

In addition, if a recession is partly caused by over-investment in a particular sector, two forces drive down jobs in that sector, but one is temporary. For example, home building exceeded demand, and those extra jobs were unnecessary. But, by reducing inventories of homes, employment will fall even further. Once excess inventories are worked off, the industry will be adding jobs, even if it does not ramp up to the previous peak in production.

Nonetheless, some still look for a catalyst to end the panic that started this Fall. Consumers and businesses have pulled back, basically hoarding cash, to the point of driving down the T-bill interest rate to zero. Part of this was because many people lost faith in the banking system, but the end result was a sharp decline in the velocity of money. Only once in history has something like this spread in a long-term downward spiral and that was in the Great Depression.

But, in the Depression, the real problem was that the Fed let the money supply collapse, which in turn shut down aggregate demand. This is not happening now. The Federal Reserve is making sure a persistent deflation will not take hold and is adding liquidity to the system as rapidly as it can. As a result, we expect both money growth and a turnaround in velocity to start healing in the months ahead. In fact, given the unexpected increase of 0.5% in "core" retail sales in November, this may already be happening.

In other words, the catalyst for recovery is attached to the very eyes that are looking for it. As long as human beings attempt to better themselves and improve standards of living, and as long as policy-makers don't compound problems, the natural course of growth will return in its magical and mysterious way.

| Date/Time (CST) | U.S. Economic Data | Consensus | First Trust | Actual | Previous |
|---|---|---|---|---|---|
| 12-15 / 7:30 am | Empire State Mfg Index - Dec | -28.0 | **-25.0** | -25.96 | -25.4 |
| 8:15 am | Industrial Production - Nov | -0.8% | **-1.0%** | -0.6% | +1.3% |
| 8:15 am | Capacity Utilization - Nov | 75.6% | **75.5%** | 75.4% | 76.4% |
| 12-16 / 7:30 am | CPI - Nov | -1.3% | **-1.6%** | | -1.0% |
| 7:30 am | "Core" CPI - Nov | +0.1% | **+0.2%** | | -0.1% |
| 7:30 am | Housing Starts - Nov | 0.738 Mil | **0.700 Mil** | | 0.791 Mil |
| 12-18 / 7:30 am | Initial Claims - Dec 13 | 555K | **569K** | | 573K |
| 9:00 am | Philly Fed Survey - Dec | -40.2 | **-39.8** | | -39.3 |
| 9:00 am | Leading Indicators - Nov | -0.4% | **-0.6%** | | -0.8% |