

Staff:

Grace Y. Lau, CFA
Chief Executive Officer

Carter A. Pearl, CFA, CFP
Senior Portfolio Manager

Elliot Kauffman, CFA,
Senior Portfolio Manager

L. Jane Helst, CPA
Portfolio Manager

Daniel S. Flack, CFP, CFA
Portfolio Manager

Carolyn Folks
Trust Specialist

Danil Faust
Operations Specialist

Lucy Lee
Administrator

Office:

Phoenix:

1643 E. Bethany Home Rd.
Phoenix, AZ 85016

Tel: (602) 997-8882
(888) 997-8882

Fax: (602) 997-8887

www.pacwestfn.com

Monetary Velocity is Key

The path of the business cycle follows a regular pattern. However, the timing, extent, and duration of each cycle can vary widely.

We are currently at the point in the business cycle where cutbacks in spending by the consumer and business have resulted in an over-supply condition. **The economy has excess supplies** in housing, autos, apparel, and even oil. Most everything is on sale in an attempt to reduce inventories.

Eventually, the over-supply condition will self correct. Companies are scaling back on production and creating less additional supply. Fewer homes and autos are being built, and less oil is being pumped. Supply cuts often overcompensate for the corresponding slack in demand because of the high level of excess inventories. Thus, once the excess inventories are liquidated, the level of supply in the economy will most likely be too low even for the economy's current lower level of demand. When we reach that point, prices will firm.

In the meantime, the government is trying to ease this economic adjustment by increasing spending to help reduce the slack caused by the reduction in consumer and business spending. Tax cuts and deficit spending will help support overall demand and reduce the over contraction of supply.

As we explained last month, lower interest rates will also stimulate spending and eventual economic growth. Normally, credit expansion by the private sector (consumers and businesses) precedes economic expansion. And this is exactly what we are looking for in order to call a bottom for this economic cycle. The stock market usually anticipates such a bottom and normally begins to rally on average six months prior to an economic bottom.

In order to anticipate the bottom in stock prices, we are looking for signs that the velocity of money is increasing. The velocity of money is a measure of how fast money changes hands in the economy. To understand why the velocity is important, I'll need to digress for a moment and explain the quantity theory of money and credit.

The quantity theory is expressed using the formula $M * V = P * T$, where M = the money supply, V = the velocity of money, P = the price level, and T = the transactional level. In a normal economic expansion, M (the money supply) increases as credit expands, and V also increases because consumers tend to pur-

chase when they receive money rather than save. Increased credit (M) and increased spending (V) results in an increased transactional level (T), which in America we call Gross National Product. The price level (P) will remain constant until T has reached a point where the economy is operating at full capacity. At that point, T can no longer rise, so additional increases in M and V will result in an increasing P, which we call inflation.

When inflation becomes a problem, the government restricts credit expansion, thus reducing M. V also declines with M, which results in lower P and potentially a lower T. However, a declining T is called a recession. When recession becomes a problem, the government increases M in an effort to increase T. In some recessions, reducing interest rates in order to stimulate credit expansion (increase M) is enough to entice consumers and businesses to resume spending, and thus increase T.

In the current cycle, the government has expanded M by reducing interest rates and giving money to banks, however, the money has not yet found its way to consumers and businesses. In this case, money is changing hands at a slower rate. Thus, even though M is increasing, there is a corresponding decrease in V, and therefore, no corresponding increase in T. Fiscal stimulus in the forms of tax cuts and deficit spending by the government will help to get more money to consumers and business. **If the private sector spends the money, V will increase, and the economy will once again begin to expand.**

With most everything on sale, low interest rates, and an aggressive fiscal stimulus package, **the stage is set for excess inventories to be absorbed.** Currently, consumers are deferring purchases, expecting that prices may drop further. However, production has already scaled back, and so prices will firm as the excess inventory is reduced. The firming of prices may put an end to the waiting behavior of consumers resulting in the release of pent up demand.

News travels fast, and so a change in consumer behavior and market sentiment can happen quickly. The markets are currently pricing in a very pessimistic outlook. **If the outlook changes to less pessimistic, that could be enough to spark an anticipatory market rally.**

ASSET ALLOCATION: With cash now yielding very little, and our current over allocation to investment grade bonds in place, we expect to increase exposure to equities as we see more evidence of improving conditions.

Grace Y. Lau, CFA
Elliot C. Kauffman, CFA