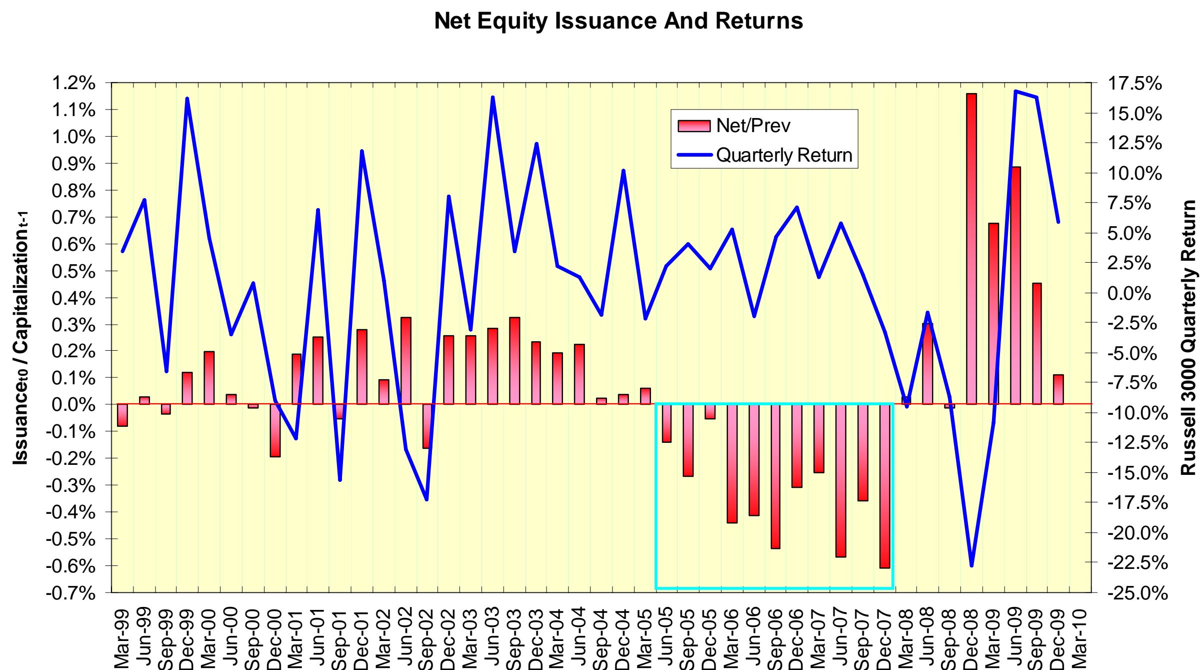
Honey, I Shrunk The Equity

Let's assume, just for the sake of argument, a certain central bank might wish to solve the problems of the last credit bubble by re-inflating another credit bubble. This is still all hypothetical, mind you, as the ongoing campaign of low interest rates and quantitative ease has yet to culminate in the inevitable "Everyone gets approved" credit bubble, but I do not use the word "inevitable" by accident. As time keeps on slippin', slippin', slippin' into the future, credit standards once again will vanish.

One of the consequences of the last credit bubble was a veritable orgy – I would settle for a non-veritable orgy on most days, but that is getting a tad off-topic – of leveraged buyouts, acquisitions and privatizations leading to the shrinkage of available equity. Some attributed the bull market of 2003-2007 in part to this shrinkage, measured by the Federal Reserve's flow-of-funds net issuance of equity for that quarter divided by the market capitalization at the end of the previous quarter. The shrinkage era, 2005:Q2 to 2007:Q4, is highlighted with a turquoise rectangle in the chart below.

Net Equity Issuance And Returns

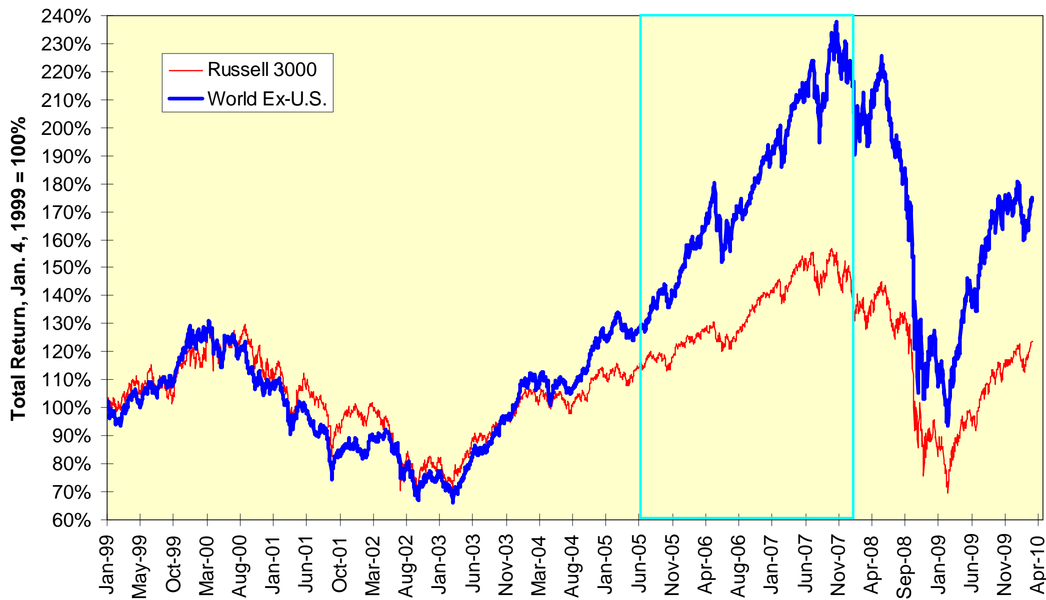


This is all very well and good unless you happen to notice quarterly returns for the U.S. market as measured by the Russell 3000 index were positive for many quarters both before and after the Shrinkage Era (which occurred right after baseball's Steroid Era. Let that be a lesson to you). Moreover, the quarters with the largest net issuances of equity, 2008:Q4 and 2009:Q2, were accompanied by very large negative and positive returns, respectively.

Global Risk And Return

There are two components to performance management, risk and return. Those who have high returns never have to apologize for the risks they assumed; those who have great risk management but no returns are cheered only during the depths of the worst bear markets, and quietly at that.

If we map the total returns for the Russell 3000 and the MSCI World Ex-U.S. index in dollar terms reindexed to the January 1999 advent of the euro and overlay the Shrinkage Era upon it, we see how much the U.S. underperformed the rest of the world both then and during the bull market of the past year.



If we run a simple regression model, US = f(World Ex-U.S.) over the three periods of before, during and after the Shrinkage Era, we find all three periods are different from each other at near 100% confidence. However, the quality of the fit as measured by r^2 or percentage of variance explained, was greater once the Shrinkage Era began.

The net result of equity shrinkage both during and after the period defined was to move the risk of American stocks up to the risk of non-U.S. stocks. This is equivalent to saying a global investor can survey the landscape and opt for equivalent risk *ex ante* with full recognition returns will be assessed *ex post*. The more official policies push us through a continued low-rate environment and try to create a credit bubble, the riskier U.S. stocks will become.