Financial Stocks And The Yield Curve

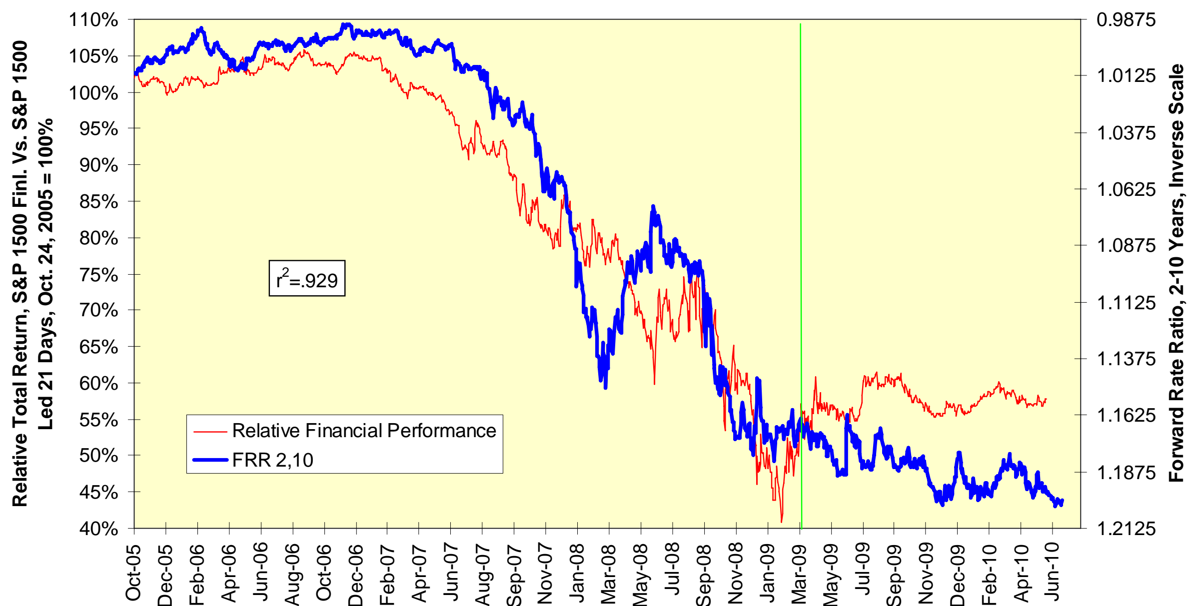
One of the more shocking factoids of my youth occurred before I knew what a factoid was and did far more shocking than being shocked: Defense stocks were underperforming the broad market during the Vietnam War. This seemed rather strange given the military expenditures at the time, but it could be explained by a combination of the government's contract management policies, the high capital costs required and the inevitable end to the whole affair.

What if I were to tell you financial stocks have underperformed the broad market since the October 2005 appointment of Ben Bernanke to the chairmanship of the Federal Reserve. Given the Chairman's proclivities for rate-cutting and quantitative easing, along with some extraordinary crisis management during the financial crisis, (I have a better chance of naming all African countries, which I once did on a bet, than I do of reciting all of the special facilities the Federal Reserve and Treasury created in 2007-2008) most people would think the financial sector would have had a chance of outperforming the broad market.

Ha.

If we map the relative total returns of the S&P 1500's financial sector to the S&P 1500 Supercomposite itself against the forward rate ratio from two to ten years ($FRR_{2,10}$, this is the rate at which we can lock in borrowing for eight years starting two years from now, divided by the ten-year rate itself), we find the $FRR_{2,10}$ leads relative performance by 21 trading days on average. All the quantitative easing of March 2009, marked on the chart with a green line, did was stabilize relative performance.

Financial Stocks And The Yield Curve During Bernanke Era

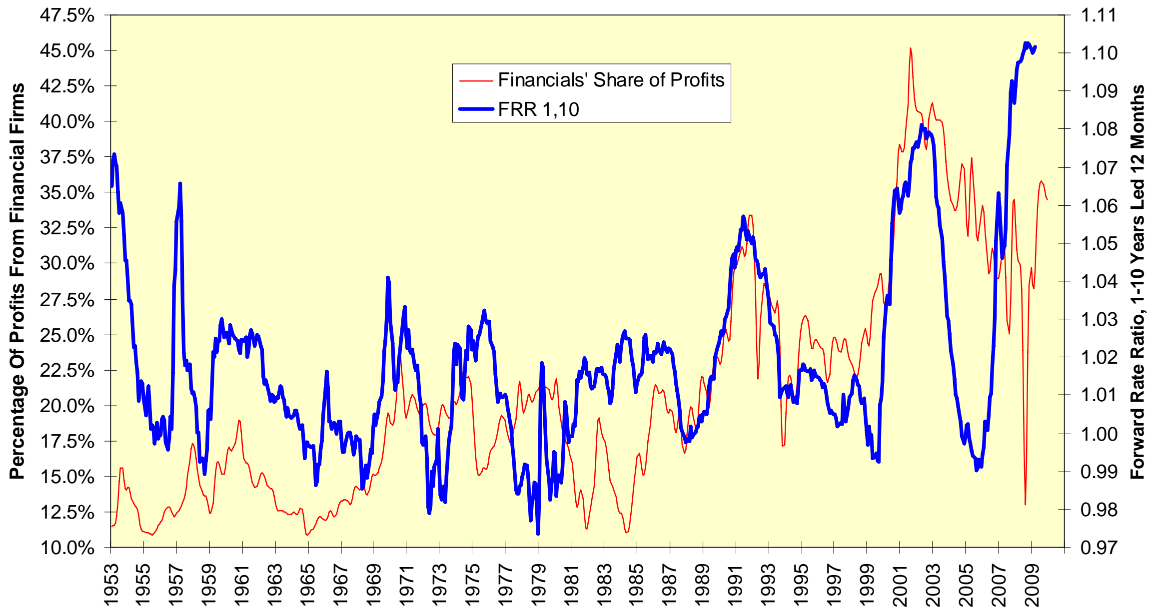


The reasons for this lackluster performance include the very same government overhead that affected the defense industry forty years ago and the inevitable end of the life-support system. History both repeats and rhymes.

Who Leads Whom?

Even though a general sense banks are getting fat off the yield curve trade pervades the land, this is not particularly visible in the share of national corporate profits derived from financial firms (Footnote: Oh for the glory days of 2001 when more than 40% of American corporate profit derived from paper-shuffling! Did we have that game beat, or what?). That percentage rebounded to 34.5% at the end of the first quarter.

Relative Financial Profits Lead The Yield Curve, Not Vice-Versa



Now take a look at which market is leading the relationship: The relative profitability of the financial sector leads changes in the yield curve, here measured from one to ten years, by twelve months on average. Restated, the Federal Reserve, whether intentionally or not, responds to the financial sector's profitability in setting monetary policy.

And if the stock market performance is any indication, these efforts do not redound to the benefit of shareholders in financial firms. Somehow this feels like we have been invited to join a circular firing squad.