The Unbearable Triteness Of Easing

If a culture can be defined as a set of shared beliefs, then one of the bedrocks of financial market culture is financial firms are linked directly to the shape of the yield curve. It is easy to understand how and why this belief arose over the years; a bank, for example, tends to borrow money at short-term interest rates for subsequent lending at long-term interest rates, so it stands to reason the steeper the yield curve, the greater the interest rate carry.

Policy actions designed to rescue financial firms from themselves inevitably involve cutting the target for overnight federal funds and creating excess reserves within the banking system. The idea reached its full and final flower in the U.S. in 2008-2009 with the December 2008 cut in the federal funds rate to a level between 0-0.25% and with the March 2009 quantitative easing; both policies remained intact throughout 2010. The idea behind both moves was to encourage consumers to spend now rather than later and to encourage business investment by lowering the cost of capital.

The logic was flawed on several counts, as the country and the world found out the hard way. First, lowering the return on savings often leads to an increased supply of funds available for saving as the only way to increase investment income is to increase the quantity saved. Second, if the economy is soft, why would anyone borrow to increase investment in plant and equipment? Third, if banks can make an easy portfolio profit on borrowing from the Federal Reserve at 20 basis points and lending to the Treasury at 350 basis points, why should they take on the risky business of lending to commercial customers? Finally, Japan's long and unhappy experience after 1990 indicated any attempt to resuscitate a domestic economy via low short-term interest rates would be defeated by global carry trades; these involve borrowing the cheap money printed in one country to lend or invest at a presumably higher return elsewhere.

Financial Stock Relative Performance

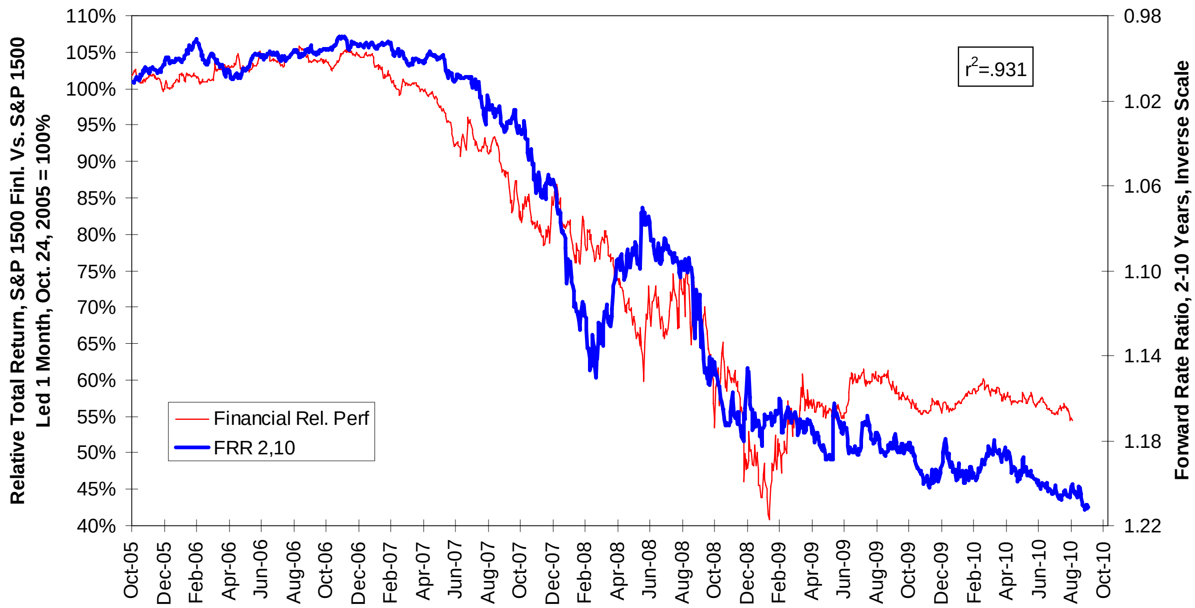
The simple and incontrovertible truth of the matter, the Great Ignored of the financial culture, is the relative total return of financial stocks to the broad market during the Bernanke era has been an unmitigated disaster. Let's index the total return of the S&P 1500 financial sector relative to the S&P 1500 Supercomposite as a whole to the October 24, 2005 date when then-President George W. Bush appointed the man known as "Helicopter Ben" for some ill-chosen words in a 2002 speech to be the next chairman of the Federal Reserve. The average annual rate of financial stocks' underperformance has been 13.41 percent, and that has occurred within the context of a negative stock market as a whole. If anyone thinks the Federal Reserve went out of its way to reward Wall Street during the financial crisis of 2008-2009 – and anyone can be excused for doing so – then Wall Street should start asking Washington to steer its largesse toward non-American financial firms out of the spirit of all's fair in love and war competition.

Two Yield Curves

First, let's map the relative performance measure of financial stocks led one month against the forward rate ratio (FRR) between two and ten year Treasuries plotted inversely. 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. The more this FRR exceeds 1.00, the steeper the yield curve is and the greater the potential carry income for financial firms.

The results are likely to be surprising for many; the underperformance of the financial sector increased with a steeper yield curve rather directly. The r^2, or percentage of variance explained, for the relationship is 0.931.

Financial Stocks And The Yield Curve



This relationship is confirmed at the industry group level. If we calculate the regression betas between the industry groups within the S&P 1500 Supercomposite and the FRR and retain only those statistically significant at a 90% confidence level, we see a very large representation of financial groups, highlighted in yellow, whose relative performance beta to the FRR is negative: The steeper the yield curve, the more these groups underperform the broad market. Of course, the economic logic may be reversed here; it may be more proper to say the worse the financial sector performed, the more the Federal Reserve cut short-term interest rates and expanded excess reserves.

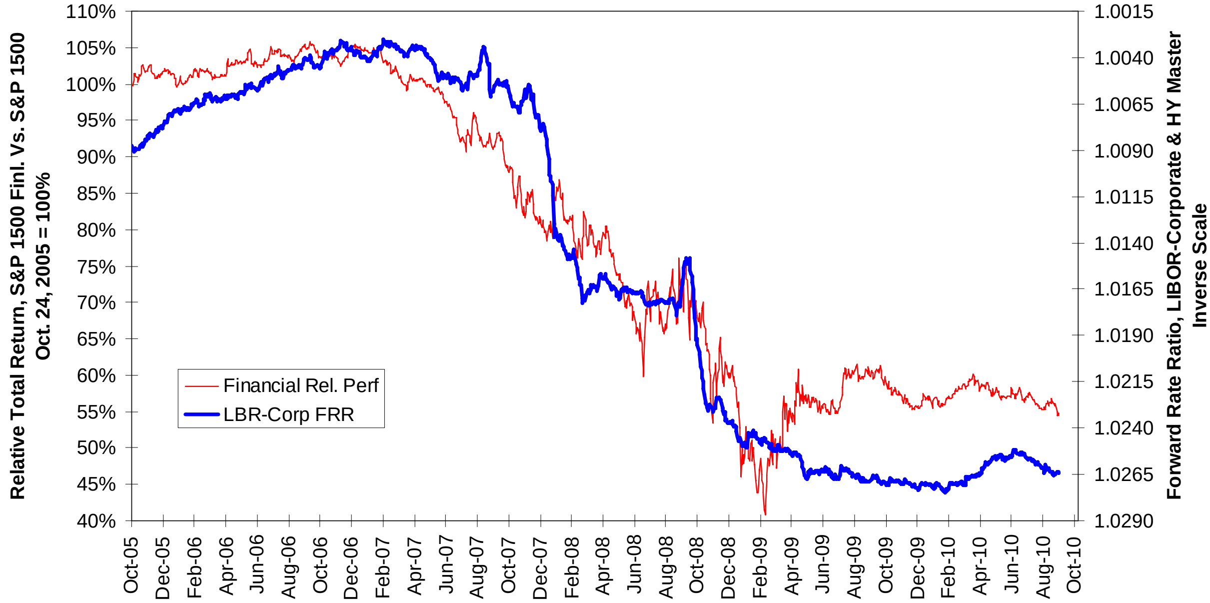
Yield Curve Beta-Weighted Impact On S&P 1500

	SPR Weight	$FRR_{2,10}$ Beta	Weighted Beta
Other Diversified Financial Services	3.31%	2.601	0.086
Diversified Banks	167%	2.135	0.036
Investment Banking & Brokerage	127%	2.317	0.029
Regional Banks	146%	1668	0.024
Asset Management & Custodial Banks	1.15%	1919	0.022
Life & Health Insurers	104%	1486	0.015
Consumer Finance	0.80%	1912	0.015
Oil & Gas Equipment	160%	0.648	0.010
Industrial Conglomerates	2.11%	0.474	0.010
Multiline Insurers	0.40%	2.481	0.010
Property & Casualty Insurers	2.22%	0.403	0.009
Retail REITs	0.52%	1550	0.008
Specialized REITs	0.71%	1050	0.007
Specialized Finance	0.40%	1287	0.005
Steel	0.38%	1341	0.005
Residential REITs	0.36%	1343	0.005
Office REITs	0.31%	1349	0.004
IT Consulting & Services	181%	0.222	0.004
Thrifts & Mortgages	0.23%	1514	0.003
Diversified Metals & Mining	0.33%	1056	0.003
Construction & Farm Machinery	114%	0.278	0.003
Automobile Manufacturers	0.39%	0.801	0.003
Construction & Engineering	0.29%	1036	0.003
Diversified REITs	0.17%	1649	0.003
Internet Retailers	0.61%	0.425	0.003
Coal & Cons. Fuels	0.26%	1011	0.003
Homebuilding	0.16%	1617	0.003
Oil & Gas Refining	0.18%	1037	0.002
Hotels	0.33%	0.527	0.002
Broadcast & Cable TV	0.22%	0.735	0.002
Industrial REITs	0.09%	1781	0.002
Apparel Retailers	0.63%	0.231	0.001
Oil & Gas Drilling	0.23%	0.577	0.001
Oil & Gas Storage	0.33%	0.346	0.001
Apparel & Accessories	0.35%	0.328	0.001
Auto Parts & Equipment	0.25%	0.402	0.001
Aluminum	0.10%	0.679	0.001
Paper Products	0.14%	0.439	0.001
Tires & Rubber	0.02%	1544	0.000
Multisector Holdings	0.04%	0.783	0.000
Forest Products	0.04%	0.527	0.000
Commercial Printers	0.05%	0.315	0.000
Subtotal:	28.10%		-34.84%

	SPR Weight	$FRR_{2,10}$ Beta	Weighted Beta
Pharmaceuticals	5.51%	0.928	0.051
Soft Drinks	2.30%	1387	0.032
Household Products	2.30%	1245	0.029
Packaged Foods	166%	1052	0.017
Electric Utilities	196%	0.793	0.016
Multiline Utilities	147%	0.897	0.013
Hypercenters & Superstores	1.19%	1070	0.013
Tobacco	148%	0.835	0.012
Aerospace & Defense	2.65%	0.454	0.012
Biotech	142%	0.748	0.011
Computer Hardware	3.12%	0.285	0.009
Integrated Telecommunications	2.45%	0.344	0.008
Restaurants	129%	0.652	0.008
Healthcare Services	0.75%	0.967	0.007
Systems Software	2.95%	0.236	0.007
Managed Health	0.90%	0.751	0.007
Internet Software & Services	166%	0.338	0.006
Drug Retailers	0.59%	0.905	0.005
Healthcare Equipment	0.42%	1066	0.005
Healthcare Distributors	0.42%	1059	0.004
Life Sciences Tools & Services	0.48%	0.838	0.004
Gold	0.25%	1586	0.004
Air Freight & Logistics	100%	0.381	0.004
Data Processing & Outsourcing	127%	0.251	0.003
Environmental Services	0.35%	0.700	0.002
Personal Products	0.24%	0.896	0.002
General Merchandise Retailers	0.48%	0.440	0.002
Food Retailers	0.31%	0.654	0.002
Food Distributors	0.19%	0.970	0.002
Gas Utilities	0.37%	0.352	0.001
Healthcare Suppliers	0.12%	0.963	0.001
Healthcare Facilities	0.16%	0.622	0.001
Brewers	0.07%	1242	0.001
Insurance Brokers	0.25%	0.342	0.001
Distillers & Vintners	0.09%	0.776	0.001
Automotive Retailers	0.23%	0.240	0.001
Distributors	0.09%	0.627	0.001
Metal & Glass Containers	0.18%	0.287	0.001
Housewares & Specialty Stores	0.14%	0.361	0.000
Advertising	0.17%	0.284	0.000
Office Services & Supplies	0.12%	0.339	0.000
Healthcare Technology	0.08%	0.474	0.000
Specialized Consumer Services	0.12%	0.297	0.000
Reinsurance	0.10%	0.362	0.000
Water Utilities	0.03%	0.624	0.000
Subtotal:	43.35%		30.76%
Total:	**71.45%**		**-4.08%**

We can add a second yield curve into the mix, one just as important to financial firms who borrow in the interbank market and assume corporate credit risk. We can create a forward rate ratio between three-month LIBOR and the Merrill Lynch Corporate & High-Yield Master index. The same relationship as seen for the Treasury FRR remains, albeit without statistical significance due primarily to the massive distortions seen in the interbank market in 2008. The message is clear: Financial intermediaries who borrow at low LIBOR levels and assume corporate credit risk do not see stock market rewards afterwards.

Financial Stocks And The LIBOR-Corporate Yield Curve

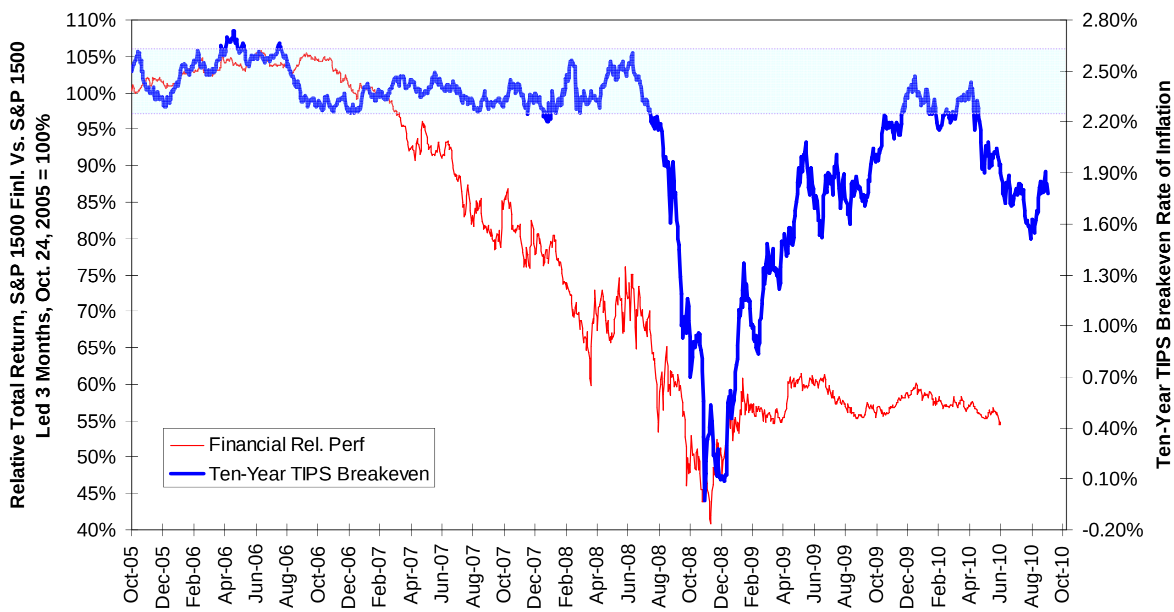


Inflation Expectations

Money illusion is a powerful force in financial markets; rising inflation expectations play tricks with the mind and lead the simplistic into confusing bloated liquidity with real productivity. As inflation tends to reward debtors and the financial sector has huge debts outstanding, then the sector is believed widely to benefit from low positive inflation levels.

However, if we map the relative performance measure led three months against the ten-year TIPS breakeven level of inflation, we see financial stocks underperformed before and during the deflation shock of 2008. As inflation expectations rebounded in 2009 toward their multiyear range highlighted in pale green, financial stocks rebounded quickly and then merely stabilized. The strategy of inflating away debt did not work here. Conversely, the April-August 2010 decline in inflation expectations did not depress the financial sector's relative performance.

Financial Stocks And Inflation Expectations



Once again, these sector-level results are confirmed at the industry group level. Only a few financial groups, highlighted in yellow, have a positive relative performance beta to TIPS breakeven rates of inflation, and the net impact is slight.

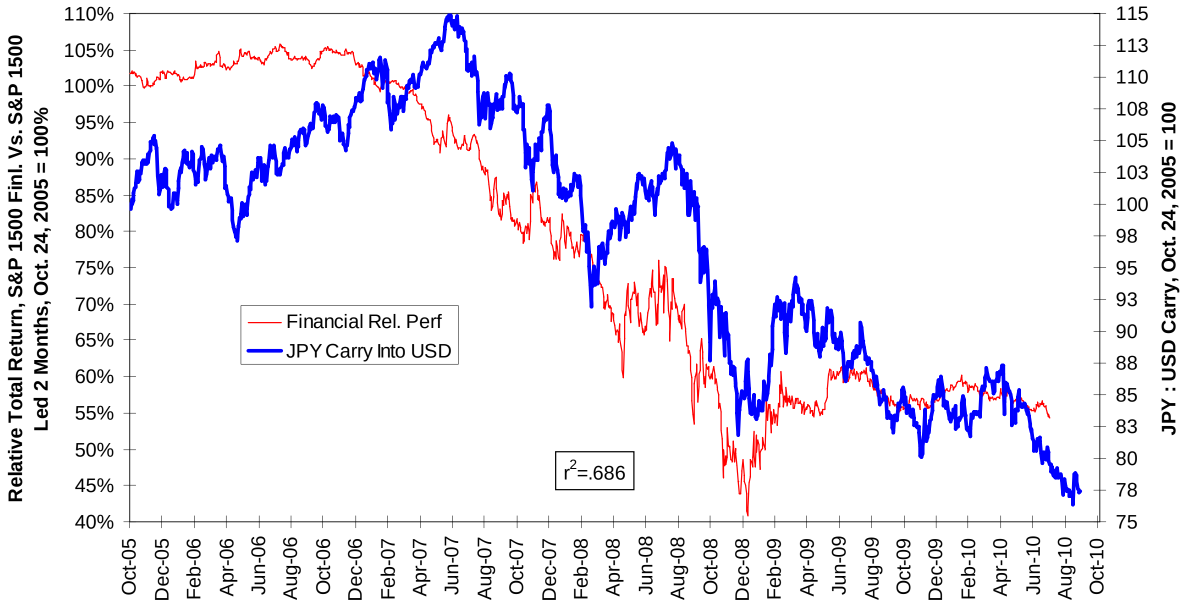
Ten-Year TIPS Breakeven Beta-Weighted Impact On S&P 1500

	SPR Weight	TIP BE Beta	Weighted Beta		SPR Weight	TIP BE Beta	Weighted Beta
Pharmaceuticals	5.39%	0.003	0.000	Oil & Gas Exploration	1.91%	0.014	0.000
Integrated Telecommunications	2.37%	0.004	0.000	Integrated Oil & Gas	5.88%	0.004	0.000
Computer Hardware	3.25%	0.002	0.000	Oil & Gas Equipment	1.64%	0.012	0.000
Semiconductors	2.25%	0.003	0.000	Other Diversified Financial Services	3.46%	0.005	0.000
Hypercenters & Superstores	1.17%	0.006	0.000	Life & Health Insurers	1.04%	0.013	0.000
Communications Equipment	2.36%	0.003	0.000	Industrial Conglomerates	2.14%	0.004	0.000
Household Products	2.21%	0.003	0.000	Movies & Entertainment	1.39%	0.006	0.000
Aerospace & Defense	2.67%	0.002	0.000	Steel	0.39%	0.011	0.000
Biotech	1.40%	0.004	0.000	Coal & Cons. Fuels	0.26%	0.016	0.000
IT Consulting & Services	1.78%	0.003	0.000	Multiline Insurers	0.41%	0.008	0.000
Soft Drinks	2.24%	0.003	0.000	Oil & Gas Storage	0.34%	0.009	0.000
Packaged Foods	1.64%	0.003	0.000	Diversified Metals & Mining	0.34%	0.009	0.000
Tobacco	1.43%	0.003	0.000	Industrial Gases	0.42%	0.006	0.000
Drug Retailers	0.60%	0.008	0.000	Wireless Services	0.35%	0.008	0.000
Internet Software & Services	1.64%	0.002	0.000	Specialized REITs	0.72%	0.004	0.000
General Merchandise Retailers	0.46%	0.008	0.000	Oil & Gas Refining	0.18%	0.014	0.000
Application Software	0.86%	0.004	0.000	Oil & Gas Drilling	0.25%	0.010	0.000
Automobile Manufacturers	0.40%	0.008	0.000	Broadcast & Cable TV	0.22%	0.011	0.000
Railroads	0.74%	0.004	0.000	Diversified Chemicals	0.83%	0.003	0.000
Restaurants	1.25%	0.002	0.000	Specialized Finance	0.41%	0.005	0.000
Healthcare Services	0.75%	0.002	0.000	Aluminum	0.11%	0.017	0.000
Data Processing & Outsourcing	1.24%	0.001	0.000	Construction & Engineering	0.30%	0.005	0.000
Environmental Services	0.35%	0.004	0.000	Industrial REITs	0.09%	0.015	0.000
Department Stores	0.34%	0.004	0.000	Gas Utilities	0.36%	0.003	0.000
Food Distributors	0.19%	0.005	0.000	Diversified REITs	0.17%	0.006	0.000
Office Electronics	0.13%	0.006	0.000	Healthcare Facilities	0.16%	0.003	0.000
Auto Parts & Equipment	0.25%	0.003	0.000	Tires & Rubber	0.02%	0.015	0.000
Footwear	0.32%	0.002	0.000	Commercial Printers	0.05%	0.007	0.000
Trading Companies	0.19%	0.003	0.000	Commodity Chemicals	0.01%	0.006	0.000
Education Services	0.17%	0.004	0.000				
Specialty Chemicals	0.50%	0.001	0.000				
Distillers & Vintners	0.09%	0.006	0.000				
Distributors	0.09%	0.006	0.000				
Metal & Glass Containers	0.18%	0.003	0.000				
Brewers	0.07%	0.007	0.000				
Automotive Retailers	0.23%	0.002	0.000				
Leisure Products	0.17%	0.003	0.000				
Building Products	0.10%	0.004	0.000				
Home Improvement Retailers	0.13%	0.003	0.000				
Trucking	0.12%	0.003	0.000				
Home Entertainment Software	0.06%	0.003	0.000				
Subtotal:	41.74%		-0.14%	Subtotal:	23.84%		0.16%
				Total:	**65.58%**		**0.03%**

Global Carry

What about those periods when it was cheaper to borrow in the Japanese yen as opposed to the U.S. dollar? We can track the total return from borrowing the yen and lending in the dollar and map it against the relative financial measure led two months. Here the results are as counterintuitive as they are for the Treasury yield curve: The lower the yen carry, which means the more U.S. short-term rates converged downward to and eventually through Japanese rates, the more the financial stocks underperformed. While this relationship deteriorated with the yen's rise after the Chinese yuan revaluation and China's purchase of yen-denominated bonds beginning in June 2010, the relationship retains a respectable r^2 of 0.686.

Financial Stocks And JPY Carry Into USD



Every culture has its myths and hypocrisies. It is part of the human experience. One shared aspect of human culture, we are sure, is through the ages mothers had certain warnings for their daughters when they reached a certain age. Central bankers would do well to learn this wisdom of the ages: Being too easy in anything is no way to achieve lasting success.