Free Money And Financial Stock Alpha

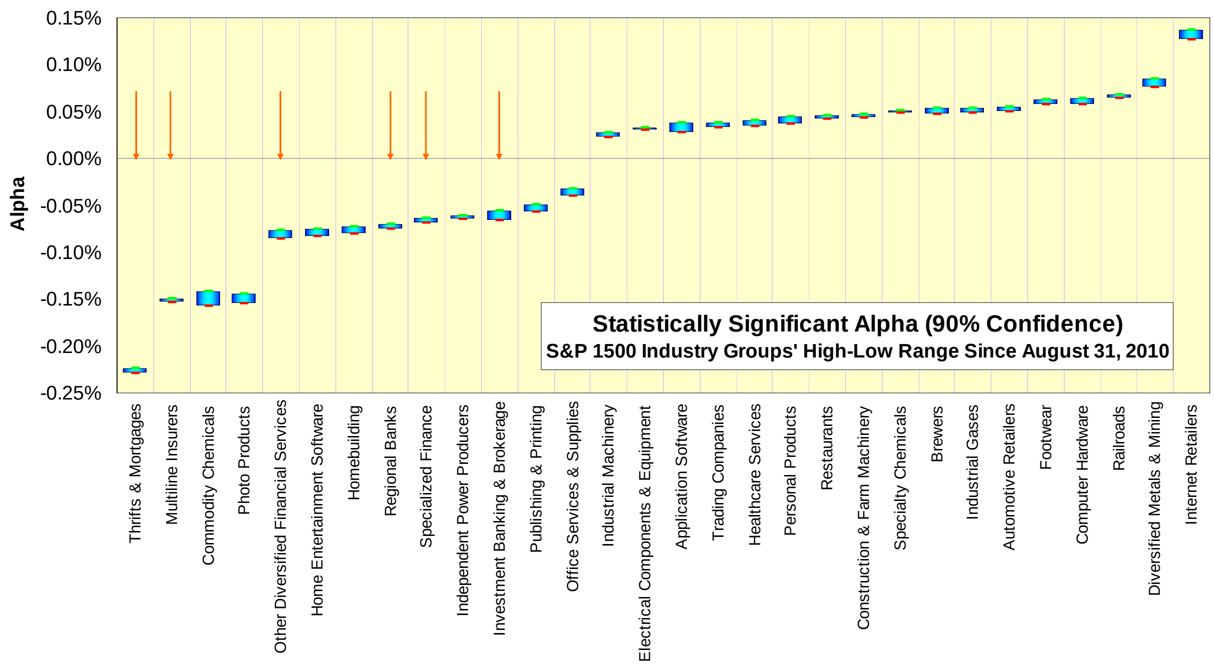
Certain observations about financial markets fall into the "rubber chicken" school of comedy: You can get a free laugh from the audience without exhibiting an iota of wit or effort. I did not set out to establish the diminishing returns on free money for financial sector performance as a rubber chicken; you can think the Johnny One-Notes at the Federal Reserve for that.

To paraphrase Will Rogers, I don't write comedy; I just follow the Federal Reserve and report the facts.

Alpha

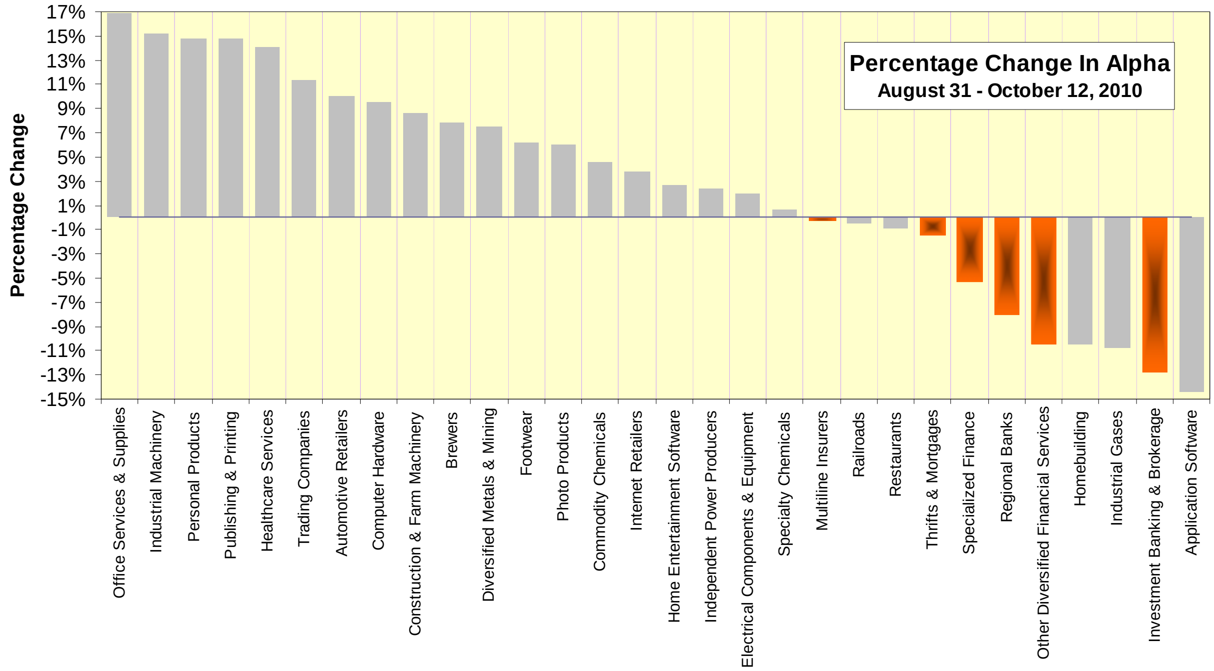
One way to separate financial professionals from respectable people is to blurt the word, "alpha," into the room. Normal people might recognize it as a Greek letter, but the financial guys will dive under the table quivering like so many PTSD wrecks, mumbling gibberish such as "efficient frontier" or "portable alpha, must add alpha." No concept has been so abused by the conference-sponsoring priesthood as alpha, the systematic outperformance of a benchmark by an asset.

If we go back to the end of the last rate-hike cycle in August 2006 – and yes, it is hard to recall we once lived through 25 basis point rate hikes at 17 consecutive FOMC meetings – we can calculate the statistically significant alpha for industry groups within the S&P 1500 Supercomposite; only 30 groups meet the 90% threshold. Five of these groups, highlighted with orange arrows, are in the financial sector. They include Thrifts & Mortgages, Multiline Insurers, Other Diversified Financial Services, Regional Banks, Specialized Finance and Investment Banks & Brokerage. Think Fannie Mae, AIG, Citigroup, Washington Mutual, Moody's and Lehman Brothers and it all comes together.



As an aside, Internet Retailers, the home of Amazon.com and NetFlix, is at the top of the chart. China makes things; we send each other DVDs. Discuss.

If we narrow the focus to the thirty-day trading period between the aftermath of the Jackson Hole speech (forget helicopters; fetch me a B-52) and last week's ersatz-money euphoria and measure the extent to which alpha changed amongst these groups, we find all six of the financial groups' already-negative alpha decreased. To repeat: The promise of free money made a bad thing worse.



The market has concluded, correctly, the end result of the free money will be compressed interest rate spread margins for as long as the low rates persist and then a painful adjustment afterwards. Moderation is a virtue in most things, and while a glass of water is welcome for the thirsty traveler, a fire hose down the gullet is not. The market is telling the Federal Reserve its more-than-enough efforts have done less-than-enough good.