Financials And The Limits To Money

Mae West may have said, "Too much of a good thing can be wonderful," but even she knew better. Anyone who is drowning in money had best consider it is still drowning and that is a fate to be avoided.

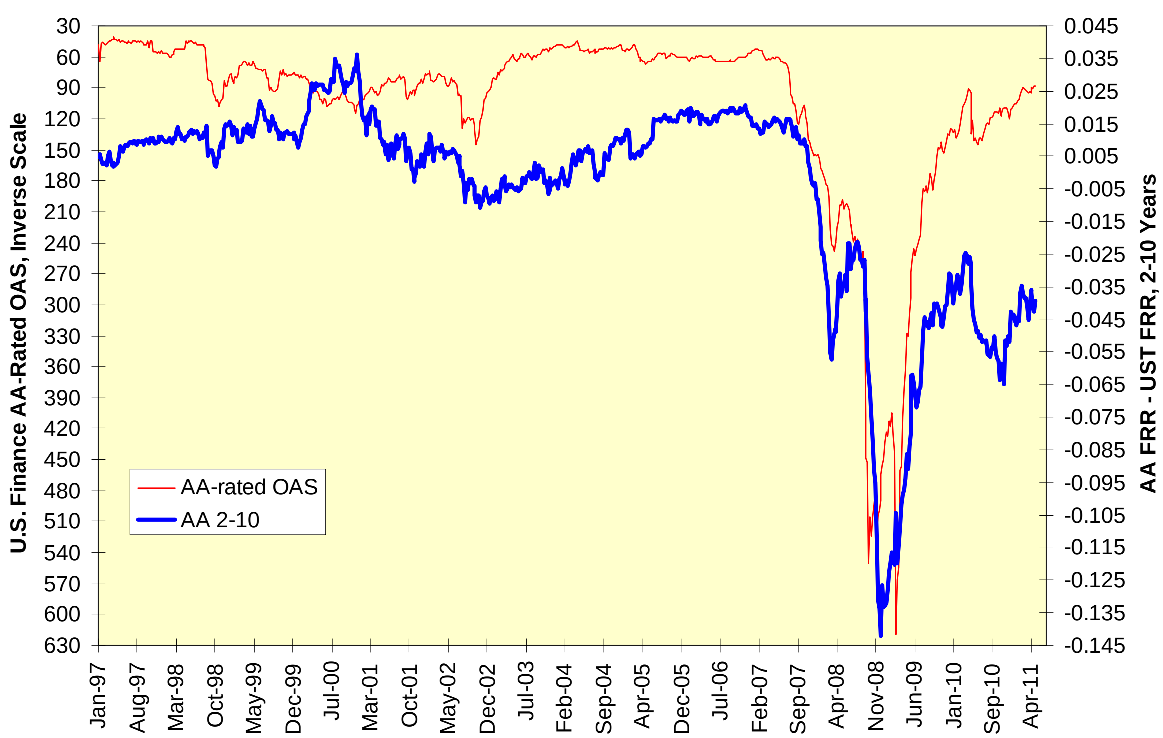
If we start going down the checklist of what money-printing and zero interest rates were supposed to do, the pencil will keep its sharp point. Reduce unemployment? No checkmark made. Promote economic growth? No checkmark here, either. Support housing prices and reduce the stress on a financial system still leveraged heavily to residential mortgages? No checkmark, unless it is to note the decline in the Case-Shiller index. About the only places where we have to use that pencil are "finance the fiscal deficit with printed money" and "create the illusion of prosperity in the stock market." Check and double-check, but not if you are counting the financial sector.

I noted in July 2010 neither the financial stocks' relative performance nor the share of American corporate profits attributable to finance were not responding well to Bernanke's tender loving care, and this was written almost two months prior to Jackson Hole. Now that we have conjured a few hundred billion dollars more out of the ether, here is the sad truth is since the execution of QE2 began in November 2010, the S&P 1500 Financials have returned 6.88% as opposed to 11.58% for the S&P 1500 Supercomposite itself.

Credit Conditions
As we learned or should have learned in 2007-2008, stocks float on a sea of bonds and if the cost of capital starts to rise on either an absolute or a relative basis for any sector, we should pay attention. Such is the case in the financial sector today.

We can illustrate this with two measures, one straightforward and the other a bit esoteric. The straightforward one is the sector's credit risk relative to the Treasury market as measured by the option-adjusted spread (OAS) for AA-rated bonds of between one and ten years' maturity. That measure, plotted inversely below, narrowed precipitously between March 2009 and April 2010 and has leveled off since. This is our first piece of evidence more money is not leading to better results for the financial sector.

AA-Rated Yield Curve And OAS Comparisons



The second measure is a little more esoteric. We can measure the yield curve between two and ten years for both the Treasury market and for financial sector bonds with their respective forward rate ratios ($FRR_{2,10}$). These are the rates at which we can lock in borrowing for eight years beginning two years from now, divided by the ten-rate itself. As the yield curves steepen, either as the result of higher long-term rates or lower short-term rates, the $FRR_{2,10}$ measures rise.

If we subtract the Treasury yield curve from the financial sector's yield curve, we see the Treasury curve is becoming relatively steeper, not as the result of higher long-term rates but rather because of lower short-term rates. This yield curve spread measure reached its post-2009 peak in April 2010 and after a post-Jackson Hole rebound has started to fizzle again. The maturity-dependent cost of credit for the financial sector is rising relative to the Treasury's cost of capital.

Is this a good thing? Absolutely not; we want to see the sector's cost of capital decline relative to the Treasury. The message now is the financial sector is becoming a riskier place.