About That Wealth Effect

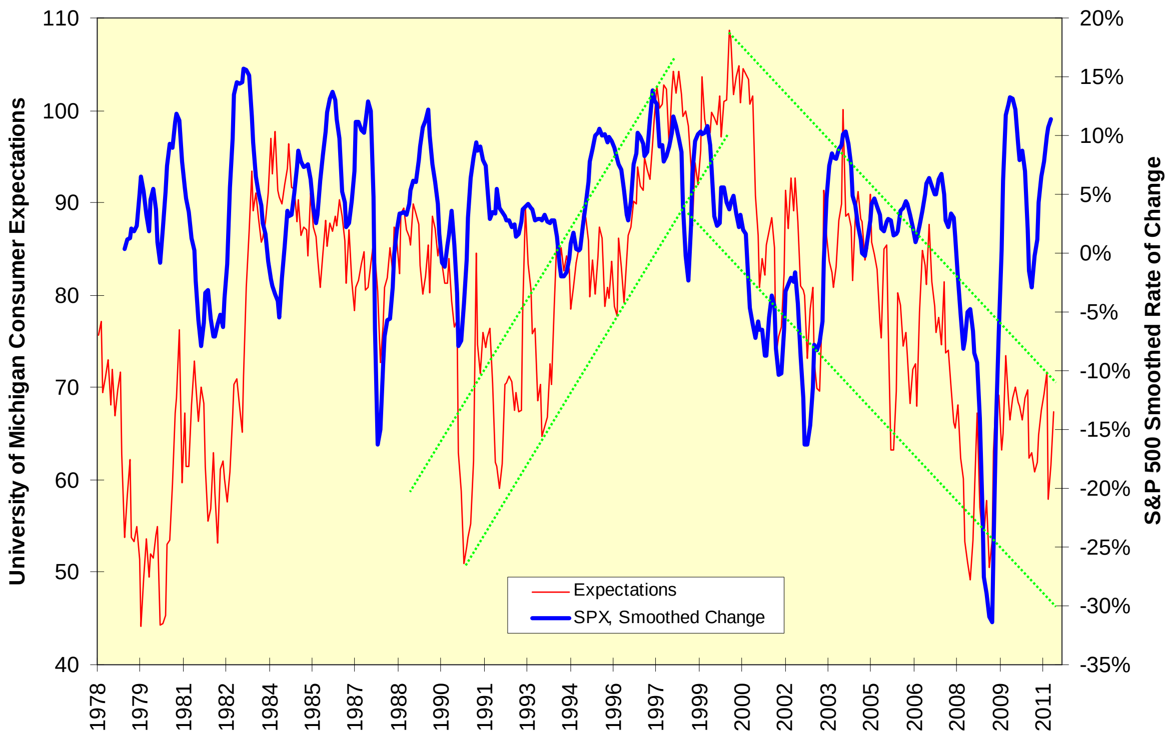
Milton Friedman and Edmund Phelps both received Nobel Memorial Prizes in economics in part for their work on the permanent incomes hypothesis, which is nothing more than a fancy way of noting people do not adjust their behavior to short-term changes in incomes but are sufficiently adult to plan around permanent income changes.

Unlike many esoteric economic theories, this one shows up in real people's lives and explains why one-time tax rebates are so ineffective at stimulating economic activity. People tend to use those rebates to pay down debts if they have them or simply to save them otherwise. It also explains why people save more when they are less confident and why graduate students who in fact are living at or below the poverty line tend to feel good about themselves.

Where do higher stock prices fit into this equation? If the Federal Reserve is trying to make them the modern opiate of the masses and delude people in general and investors in particular into believing the future is so bright they will have to wear shades, the answer has to be, "Nowhere."

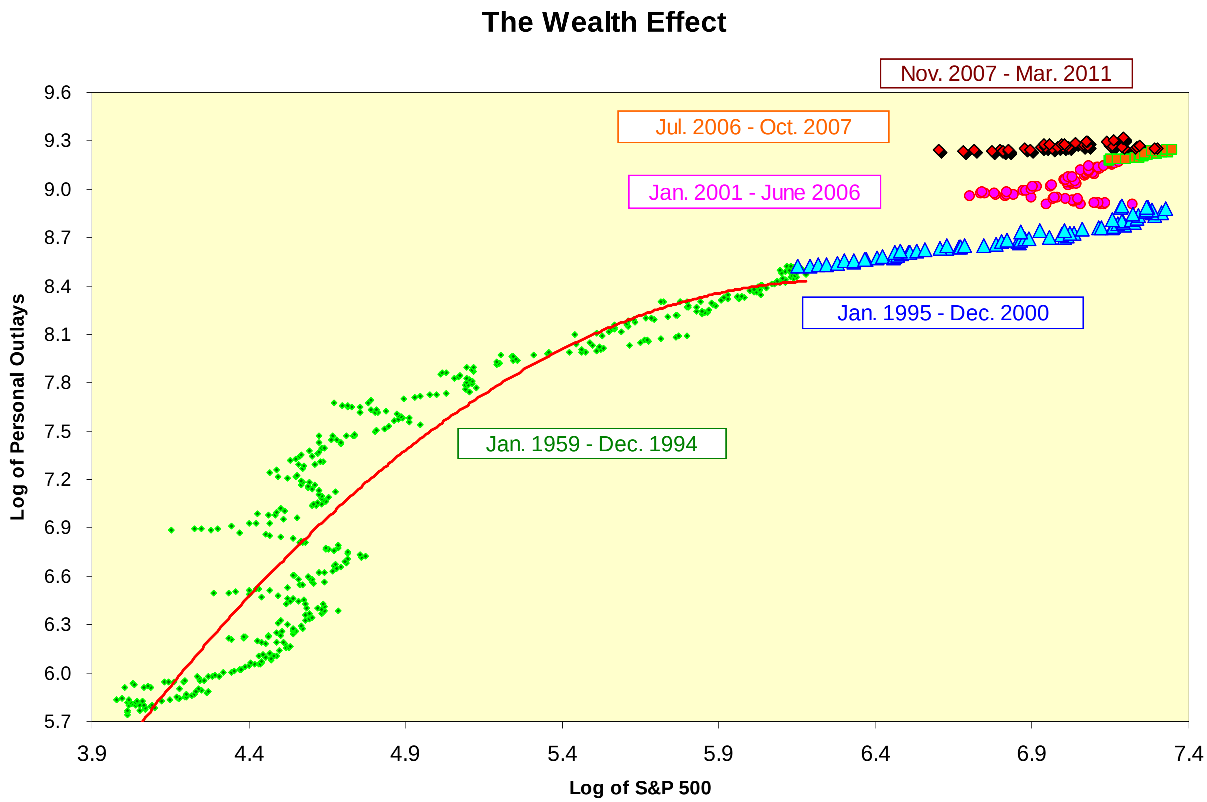
We can look at this from two angles. First, let's compare the University of Michigan's index of consumer expectations to a smoothed rate of change index for the S&P 500. The stock market has been advancing smartly higher since March 2009, but the index of consumer expectations has remained in a downward channel extending back to 2000.

Consumer Expectations And Stocks



That downward channel has an upward-sloping cousin; art imitates life. This one last for almost the entirety of the 1990s and matched a healthily advancing stock market. In fact, the expectations index and the stock market's rate of change match each other well with the very pronounced and very major exception of the past two years. This is a clue the opiate of the masses is not working very well.

Now let's map personal outlays against the S&P 500 on a logarithmic scale. I divided the history since 1959 into segment corresponding to recent bubbles in either stocks or real estate. The real key here is in the upper right-hand corner of the chart, the shadowed red markers corresponding to the start of the most recent bear market in November 2007 extending through the present. You see a wide range in the X-axis and very little in the Y-axis. Restated, the huge collapse and rebound in stock prices had very little effect on consumer outlays. Contrast this to two periods with pronounced positive wealth effects going from January 1959 to December 2000 and to the up-and-down period between January 2001 and June 2006. This last period included the mortgage equity withdrawal boom so extolled by Alan Greenspan at the time.



The Bernanke Federal Reserve has been playing a card that used to win the hand but no longer does. Investors have been trained to believe stock market gains are ephemeral and therefore are not part of their expected permanent income. In addition, the whole concept of using your home as a piggybank is over and done with for at least this generation and maybe longer.

Will this stop the Federal Reserve from trying to ignite a wealth effect that has benefited Wall Street somewhat and Main Street much less directly; I acknowledge the gains made on behalf of endowments, pension plans and the like? Probably not; this is a stubborn group willing to keep doing the same thing over and over in defiance of Einstein's definition of insanity. In other words, if you liked QE1 and QE2, you will love QE3.