Free Money And The Financial Sector

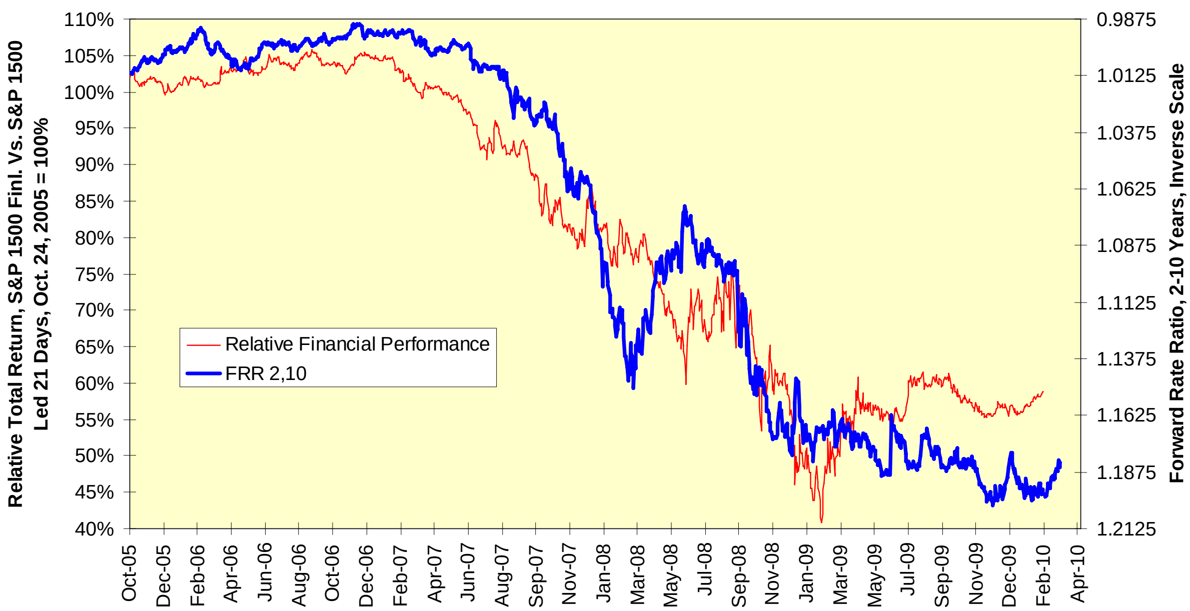
Some concepts in economics and finance can be illustrated quite simply. The next time you have a headache and reach for the proverbial two aspirin, ask yourself whether twenty aspirin would be more effective. There you have it: Diminishing and negative return on investment.

Now let's say you are the chairman of a certain central bank, a magazine cover model and the proud owner of every pile of mortgage offal created during the last housing bubble, the very same bubble this central bank has examined and decided it bears no responsibility for creating. Sooner or later, you will have to start thinking about your legacy, and you certainly do not want to wind up like your never-leave-the-stage predecessor (central bankers, likes Popes, should depart the scene feet-first. Have Alan Greenspan write the toe-tag and make everyone wonder for twenty minutes whether the stiff is actually dead or not).

Making The World Safe For Carry

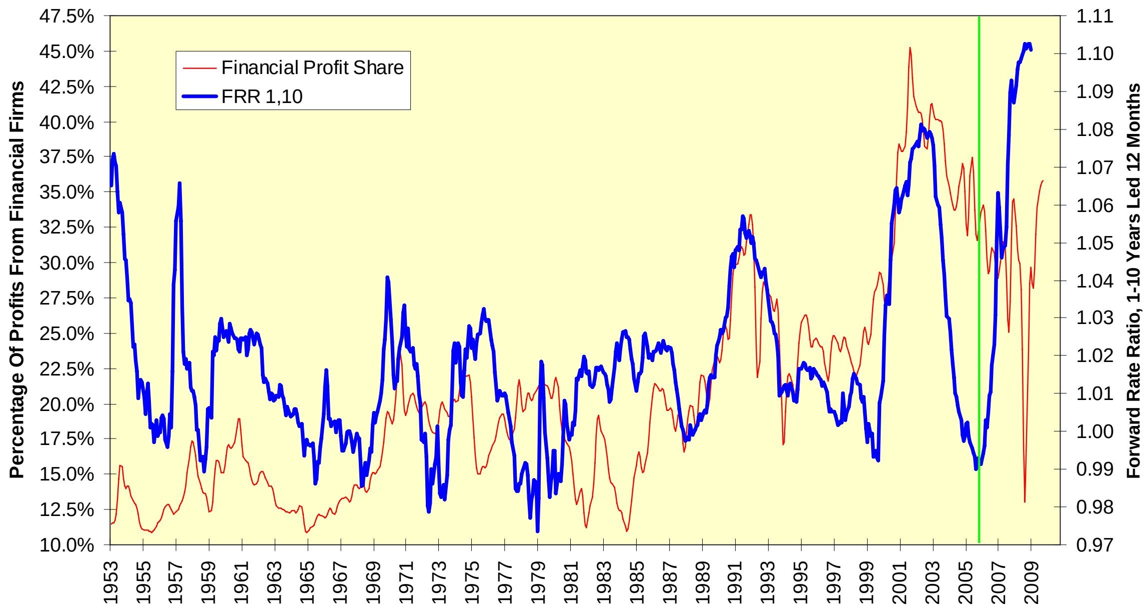
But just as Woodrow Wilson kept us out of war, for a few months at least, Ben Bernanke allowed the financial sector to gorge on cheap money, rebuild its balance sheets and, most important, to borrow short at 15 basis points so it could lend long to Uncle Sam at 370 basis points, give or take. Surely the rewards devolved to the shareholders in these banks, no? No; the relative total return of the S&P 1500's financial sector versus that of the S&P 1500 itself led 21 days declined between Bernanke's October 2005 appointment by then-President Bush and the March 2009 launch of quantitative easing even as the yield curve as measured by the forward rate ratio (FRR) between two and ten years steepened to a record. This FRR 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. After the March 2009 Ben Bernanke's Bucket-o-Bucks Bonanza began, relative performance flat-lined. The market understood: Easy come, easy go.

Financial Stocks And The Yield Curve



We see a confirming lesson from a much longer history of the share of American corporate profits generated by financial firms; here the FRR in comparison is the one between one and ten years; this measure is led by 12 months. Between 1968 and the end of 2005, the two measures dovetailed closely. Even before the yield curve went into it abrupt steepening, the relative profitability of financial firms was in decline and it has yet to rebound to previous levels even as the yield curve has remained inordinately and artificially steep. If the 1968-2005 relationship held, more than 55% of American corporate profits would derive from finance as opposed to the present 35.8%. And we wonder why everything we buy, toxic mortgages excepted, says, "Made in China?"

The Yield Curve Stopped Propelling Relative Financial Profits In 2006



Whatever good free money could have done, it has done. If we keep printing more to finance the gaping deficits, one of two things will result. The first is private sector lending revives, the money supply expands and inflation reappears. The second is the public sector will keep expanding and the resulting fiscal drag will cap growth.

If this sounds like a call for a renormalization of interest rates and an immediate crash diet for Uncle Sam – perhaps he could join one of Michelle Obama's childhood obesity tours – it is.