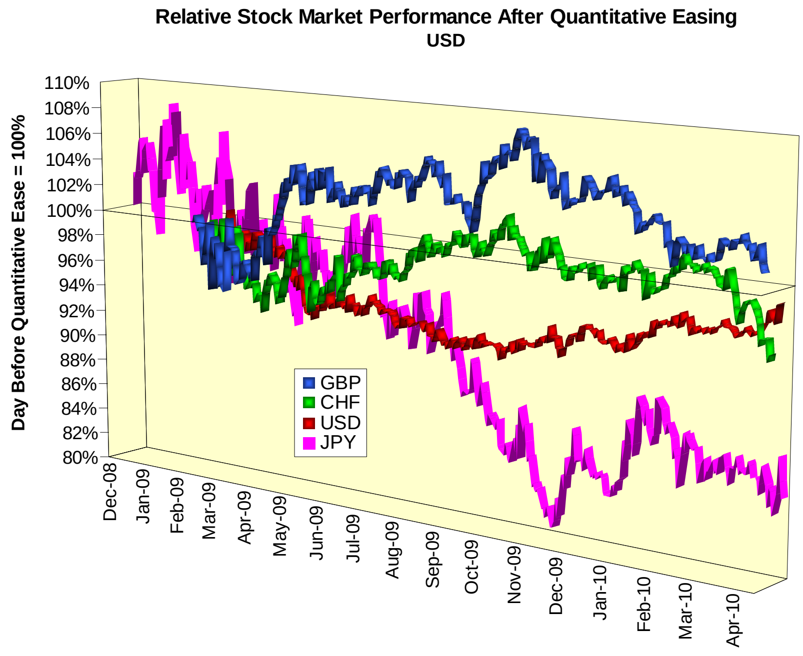
Easy Livin' And Equity Underperformance

The Federal Reserve and its sister central banks, in case anyone has missed the hint in the past two years, is determined to create yet another financial bubble as a secondary outcome to its now-primary mission of keeping the Treasury's debt service costs absurdly low. It matters not whether the asset market is housing, which has been kept over market-clearing levels by the mortgage securities buyback program, bonds of all stripes or equities: If you lower the cost of financing an asset, those lower financing costs get capitalized into the price.

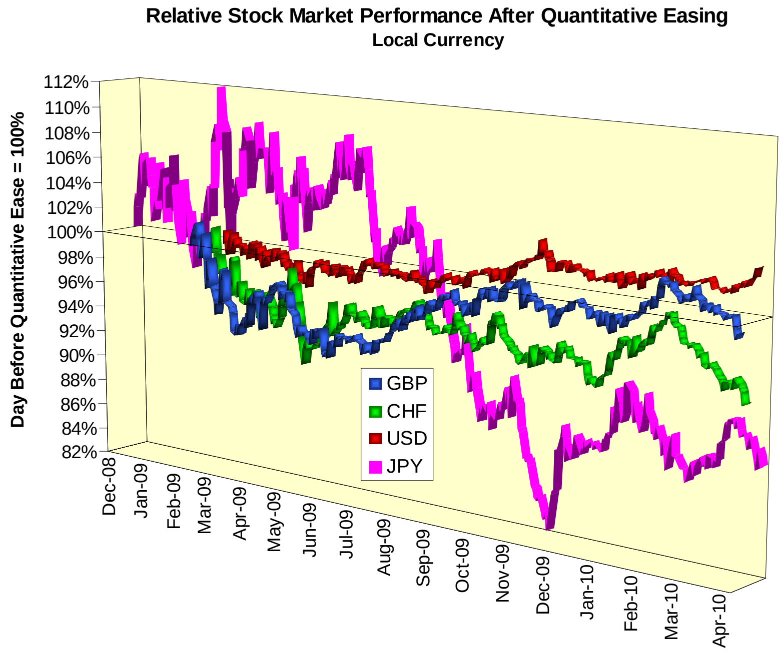
But what a dangerous web we weave when we proclaim vigilance against the deflation that surely existed somewhere on the globe between 1:10 and 1:15 AM last Tuesday while proclaiming absolute non-responsibility for both the two prior bubbles of the past decade and the one re-inflating today. One of the interesting consequences of these policies is global carry trades tend to redirect the most exuberant manifestations of asset bubbles away from the countries of origin. The cheaper dollars created here are destined to earn a lower return because the economic value added now has to be distributed across a greater supply of them; the same lesson applies to others with incontinent monetary policies. We can demonstrate this today in the realm of equities and tomorrow in the realm of bonds.

The Fab Four

Four major economies have engaged in quantitative easing, the emplacement of excess reserves in the banking system via monetization of sovereign debt, since December 2008: Japan in December 2008, and the U.K., Switzerland and the U.S. in March 2009. If we re-index each of these national equity markets relative to the MSCI-Barra World index to the day before the announcement of quantitative easing, we find three of the four markets have underperformed the global benchmark in U.S. dollar terms. Only the U.K. market has outperformed, and by a mere 1.4%.



If we repeat the exercise in local currency terms – and if you do not feel sorry for whoever has to maintain a World index in local currency terms, you should – the results switch around a little. Now only the U.S. outperforms the global benchmark, and only by 3.5%. Japan, which has been printing money since the administration of Bush 41, brings up the rear in both measures.



This all goes back to the rational expectations school of economics, which holds expected changes in monetary policy cannot affect real output and employment, only price levels. If interest rates are driven lower and an artificially steep yield curve results, you will not be rewarded with higher economic activity. This is an absurd notion; what, someone is going to invest in plant and equipment and hire labor because the overnight federal funds rate is 25 basis points? No, but they can borrow at that rate to lend it back to the Treasury at a longer maturity with the assurance those short rates will not rise over the life of the trade. They can engage in currency carry trades, too, and enrich those who are doing actual work rather than shuffling paper around and waiting for the ongoing bubble to get big enough to burst.

The madness really should stop some day.