QE-Forever: Ben Goes Self-Basting

As far as I am concerned, there has been one column ever written about behavioral finance, the one that can be summed up along the lines of, “Stop being your own worst enemy.” Even though behavioral finance excels at pointing out some of the deficiencies of the efficient market hypothesis, the late Merton Miller’s scathing description of it, a series of anecdotes in search of a theory, stands.

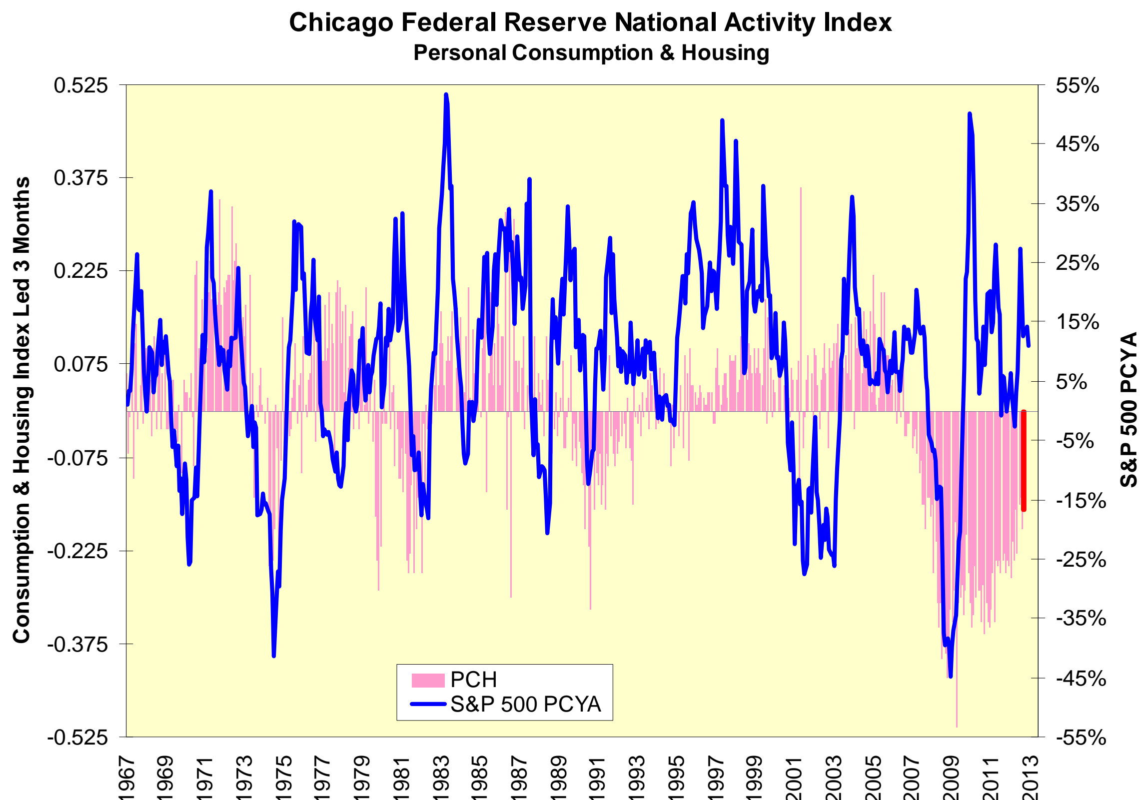
Every now and then some experiments are added to the mix to prove the obvious, such as most of us hate taking losses about three times as much as we crave winning. Then they throw in something about dopamine receptors in your brain, and you try to recall some long-ago college classes about neurotransmitters and reward centers. Ah, the social sciences!

Create Your Own Reward

Now let’s say you get to be a central banker for a few days. Sweet gig; you have all sorts of power, very little accountability and, unlike most poor schleps stuck in a job where someone else imposes performance criteria on you, you get to create your own. The goalposts go where you just kicked the ball.

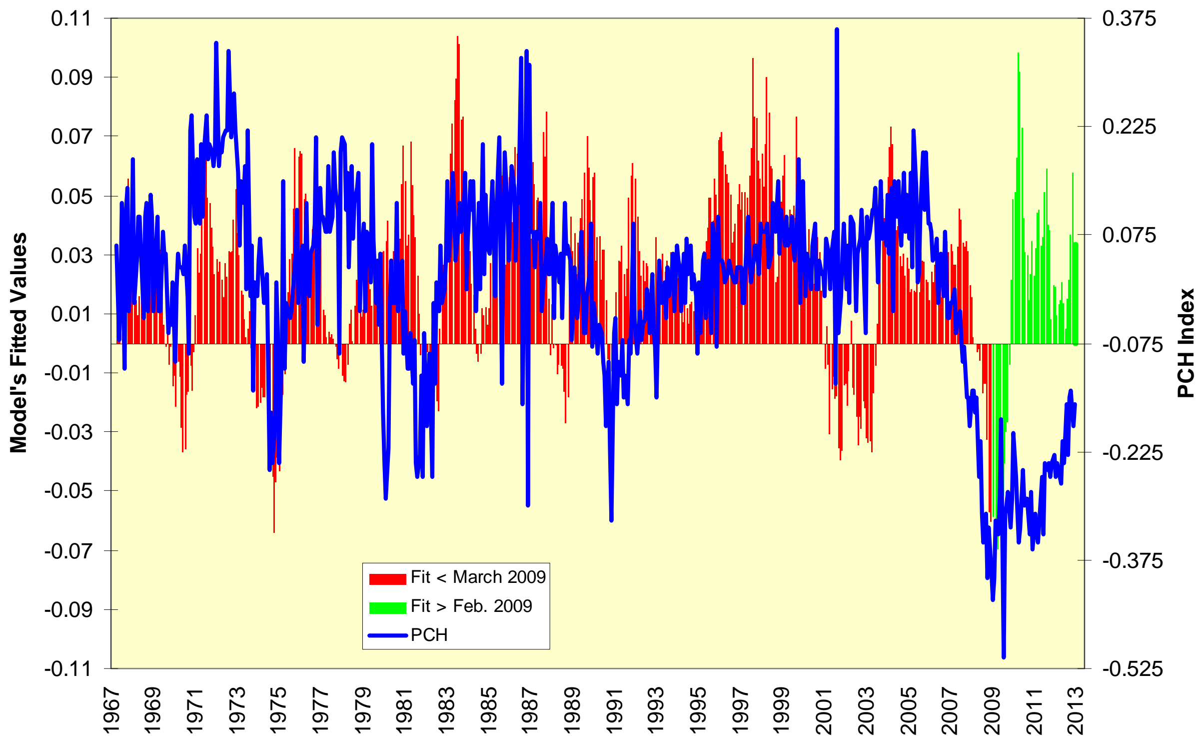
You can pretend, therefore, the goals of your money-printing policies involve employment, output and all of those boring things involved in the real economy, but what really gets your juices going and those dopamine receptors firing off in all directions is your ability to drive financial markets higher via money-printing. Let’s return to an analysis from June 2011 involving the Chicago Federal Reserve’s personal consumption and housing index (PCH). This index has been negative now for 69 consecutive months and stands lower than it did in March 2008, the month when Bear Stearns was rescued by J.P. Morgan Chase (JPM) in a deal that was to have consequences for everyone’s thought processes involving Lehman Brothers later that year.

Back in the old days, people used to think stock prices had something to do with earnings and, ha-ha, some even thought earnings had something to do with real economic growth. Were we primitive, or what? Back then the year-over-year changes in the S&P 500 led the PCH index by about three months. The new normal now is for stock prices to advance while the PCH remains in negative territory.



If we model the PCH index as a function of the S&P 500's year-over-year changes lagged three months over the June 1967 – February 2009 period and use these coefficients to project where the index should be as a function of the S&P 500, we can see just how much the misallocation of resources has cost the real economy relative to financial markets. The projected values are depicted in the green columns below.

The PCH Should Be Higher



The PCH was at -0.16 in February. It should have been at 0.033 given the robust state of the stock market. The Federal Reserve keeps telling us, and keeps telling itself in its public-yet-internal debates, it will persist with QE until certain targets are met. The evidence above suggests QE will last forever as it is wholly ineffective at accomplishing macroeconomic goals.

QE is quite effective at enabling the government to avoid fiscal discipline and at creating the illusion of prosperity for investors. If you are not complaining loudly about this, do not blame yourself, blame your reward centers and the effects of this financial opium.