QE Has Not Been As Important As We Thought

While great things can come from truths held to be self-evident, we sometimes surprise ourselves by running a few numbers and letting out a “huh!” or two. Let’s take the simple mental model shared by many that equity markets over the past five years have been financial balloons: You pump money in and the balloon expands. You stop pumping money in and the balloon stops expanding. You pump too much money in and the balloon bursts and all of the children on Wall Street start crying. You let go of the balloon and all of the children on Wall Street giggle and imitate the noise emanating therefrom.

All hail the balloon.

Different Regimes, Same Results

The U.S. policy of zero interest rates and quantitative easing got started during the dark days of November 2008 and has proceeded along since then with at least three waves of quantitative easing, a few pauses, a few planted news stories about when pauses might end or when another wave of easing would emerge. Let’s classify the era into thirteen different periods; the current one began on December 18, 2013 with the first tapering of QE and presumably will continue until the mortgage-backed security and Treasury bond buying program hits zero. That will be followed, if all goes according to some sort of master plan, with a hike in the target federal funds rate. All of this may unfold over a period extending well into 2015.

We can calculate the daily returns for the Russell 3000 index, accessible through the iShares Russell 3000 ETF (IWV), across all thirteen of these regimes. The dates of these periods and their means and standard deviations are presented below along with a probability each period is different statistically from the previous one.

Russell 3000 Returns During QE Era Subperiods

	Startdate	Enddate	Mean	Std. Dev.	Probability $Per_{t0} \neq Per_{t-1}$
1	25-Nov-08	17-Mar-09	-0.089%	2.80%	
2	18-Mar-09	31-Mar-10	0.172%	1.36%	56.5%
3	1-Apr-10	26-Aug-10	-0.101%	1.49%	89.1%
4	27-Aug-10	29-Jun-11	0.120%	0.85%	83.5%
5	30-Jun-11	26-Aug-11	-0.277%	2.37%	70.5%
6	29-Aug-11	4-Apr-12	0.122%	1.43%	69.1%
7	5-Apr-12	6-Jun-12	-0.140%	1.03%	81.7%
8	7-Jun-12	17-Aug-12	0.150%	0.94%	83.9%
9	20-Aug-12	29-Nov-12	0.013%	0.77%	60.4%
10	30-Nov-12	30-Apr-13	0.130%	0.73%	68.4%
11	1-May-13	17-Sep-13	0.084%	0.74%	**34.1%**
12	18-Sep-13	17-Dec-13	0.077%	0.67%	**5.1%**
13	18-Dec-13	29-Jan-14	0.000%	0.77%	**34.9%**

The results are telling. The last period where we could be 80% confident of different behavior was Period 8, the anticipation of QE3. Once we crossed over into 2013 and began rumbling about an eventual tapering of QE, the differences between each period and its predecessor started to blur. The FOMC managed to condition the market to a September 2013 taper, but the probability Period 11 was different from the money-printing extravaganza of Period 10 was only 34.1%.

To quote the late-night TV ads, “But wait, there’s more!” Once tapering was postponed in September 2013, the market took off into the end of the year. The probability Period 12 was different from the taper-anticipation of Period 11 was only 5.1%. Then we entered into Period 13, the actual start of tapering. That must have been very different from the postponed-tapering era, right? Not really; the probability of difference was only 34.9%.

None of this is to say monetary policy is unimportant for financial market returns. What it does say is the FOMC is not a puppet-master; markets have learned to think past the feints and nuances of various policy pronouncements and planted newspaper stories from favored columnists. All you really need to do is take out a chart of a stock

market total return series over the QE era and a ruler. You can draw a line from the start of June 2012 through the time of this writing and find very little differentiation in returns. That straight line is a simple visual confirmation of the numbers above.

Restated, policymakers may think they are being clever in their winks and nods. But just like children, markets catch on to the balloon tricks eventually.