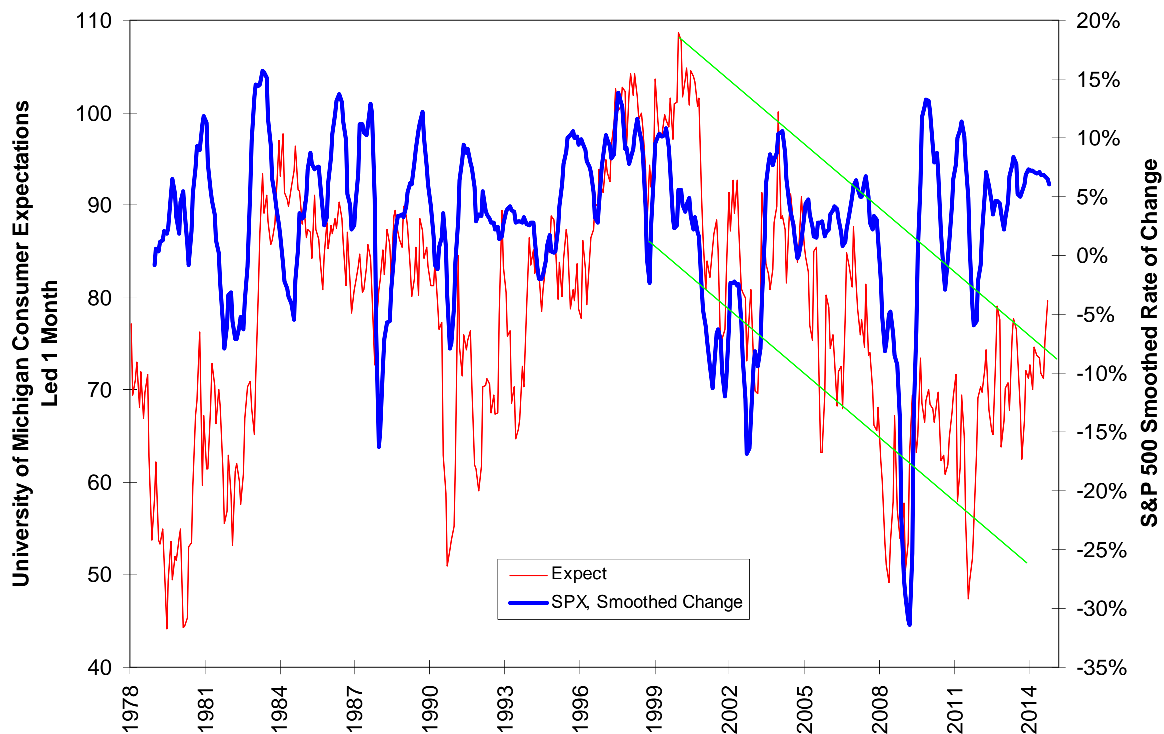
The Wealth Effect Is Returning

Here are some words I never thought I would write, "I kind of felt sorry for Ben Bernanke…." Say what? Yes, I did; all of his predecessors had been able to create wealth effects by cutting interest rates, watching either stocks or real estate soar, and then having the owners of those assets either cash them in or borrow against them to fuel consumer spending. Never mind these booms were followed by busts; you take credit for the boom and say no one could have foreseen the bust.

But things had moved a little slowly when it came to Ben Bernanke's Banana Bucks™. Even though QE2 was justified by the recent Chairman in a November 2010 *Washington Post* op-ed piece for its potential of aiding one and all via a wealth effect, the fish were not biting in their usual manner. The real estate recovery was still too uneven and the mortgage equity withdrawal mechanism was still too impaired to open that channel, and the bull market in stocks was viewed warily by shareholders who suspected the gains were ephemeral and who had lived through two vicious bear markets since 2000.

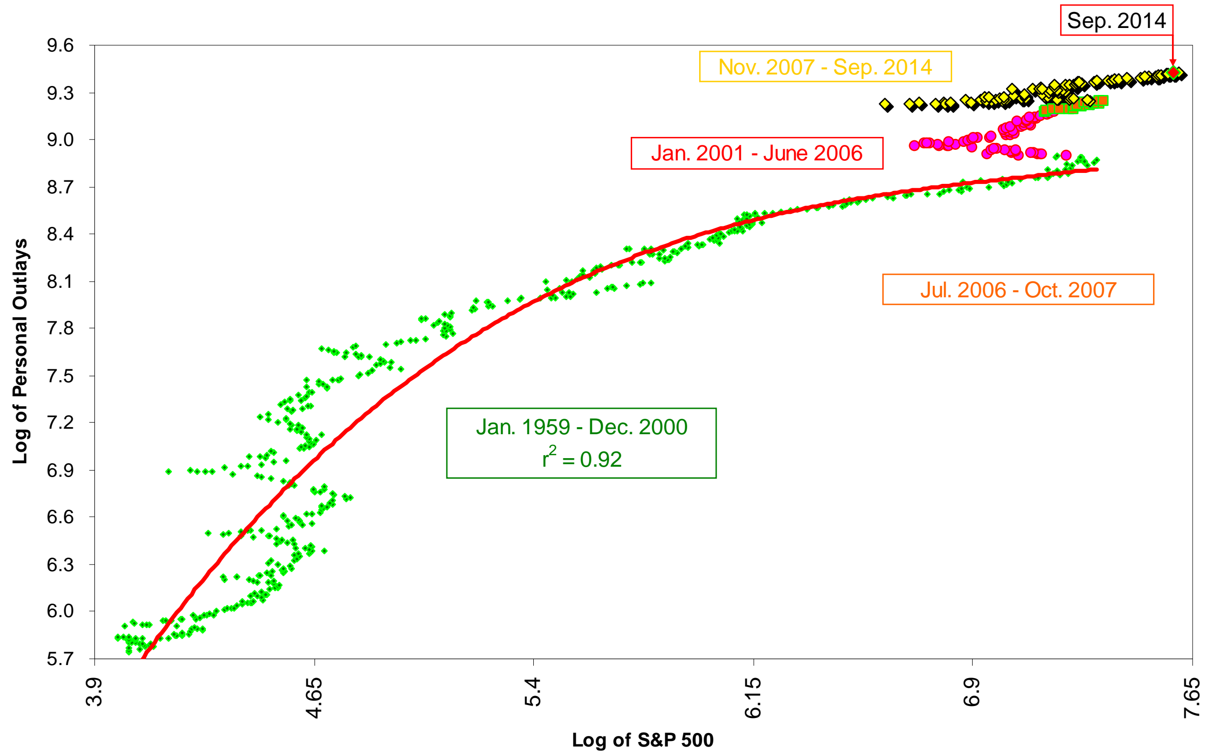
Improving Expectations
I tend to downplay consumer sentiment surveys as these measure attitudes while indicators such as retail sales measure behavior. Consumer expectations fall into this category as well. However, we should not ignore this index' upside breakout of a downtrend extending all the way back to 1999 (trend channel superimposed).



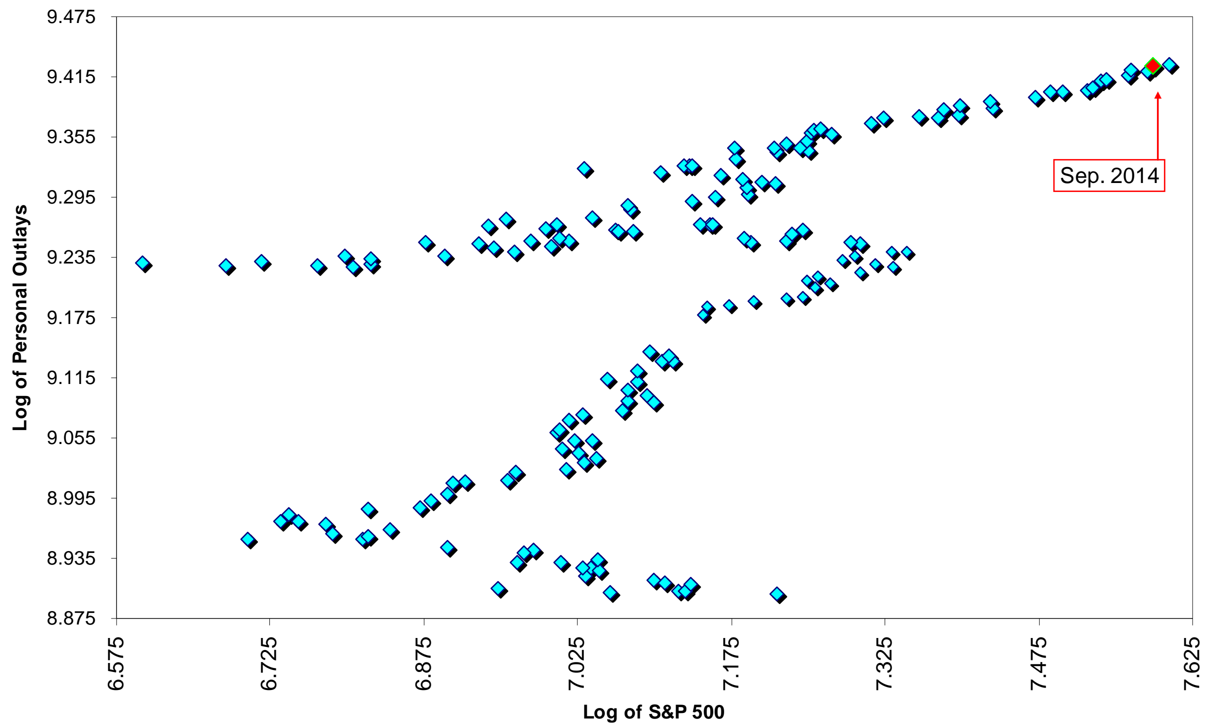
Wealth Effect
Expectations have been a one-month lagging indicator of the rate of change in the stock market as measured by the S&P 500 for more than 35 years, but it has taken a very long time for them to react to the rate of change in equity valuations. The delayed response should not be surprising as the gains in equities have been concentrated within the upper quintile of the population. The absolute level of these wealth gains has been such the long-dormant wealth effect is visible once again.

We can map personal outlays against the S&P 500 on a logarithmic basis from 1959 onwards. Four regimes are highlighted, January 1959 – December 2000 (green diamonds with red trend curve), January 2001 – June 2006

(magenta circles) and July 2006 – October 2007 (orange squares with green borders) and November 2007 – September 2014 (yellow diamonds with black shadows). A red arrow points to the most recent datum. Please note the strong linkage between personal outlays and stock prices prior to December 2000 ($r^2 = 0.92$).



Anyone, including the aforementioned Ben Bernanke, could be forgiven for assuming this relationship was a natural one. If we isolate the post-December 2000 era and display it alone on the bottom chart, the relationship turns considerably less robust.



If we concentrate on the post-November 2007 period, the beta of outlays as a function of the S&P 500 is only 0.24. The r^2 has been improving rapidly, increasing from 0.69 through February to 0.78 at the end of September.
This beta is not high by post-1959 standards, but its reemergence and increasingly demonstrable effect statistically suggest the wealth effect sought by the Federal Reserve with the launch of QE2 four years ago is being realized at last.