The Wealth Effect Will Matter

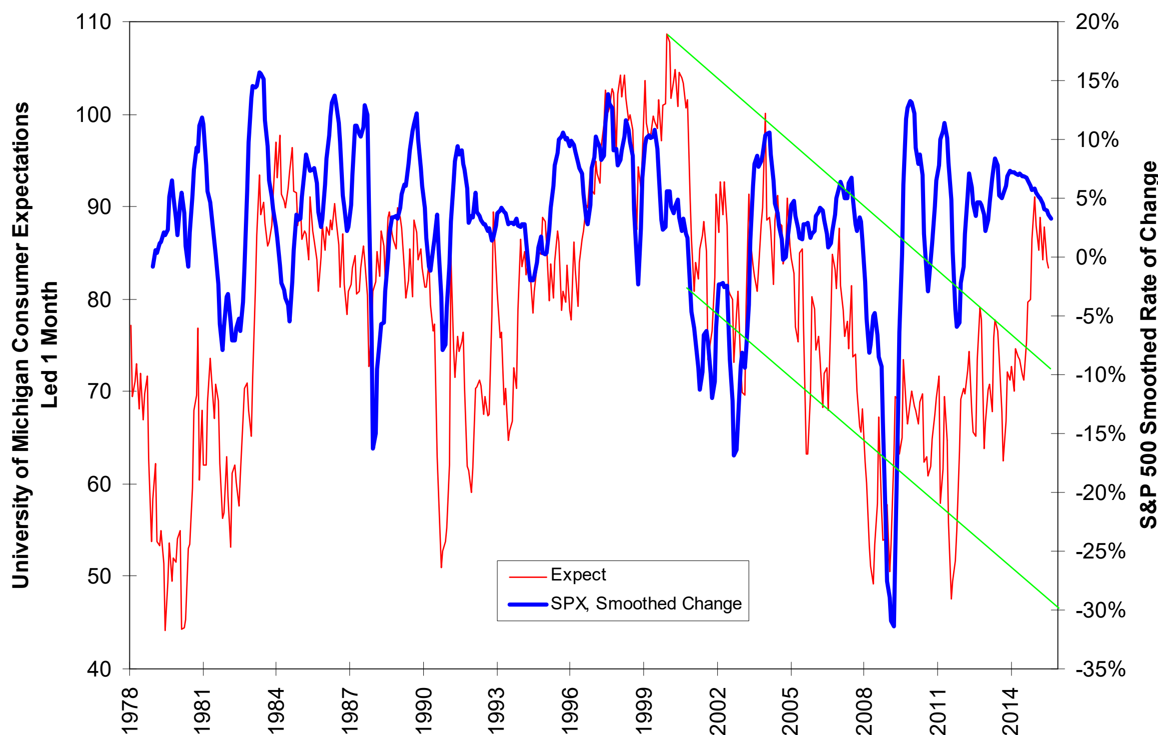
One of the biggest criticisms of the Federal Reserve's post-crisis policies is they affected household balance sheets far more than they did income statements. The stock market went up and residential real estate has recovered in an uneven fashion, but personal income growth has been slow. We can say without applying any value judgments risk-averse savers did not benefit but risk-seeking investors did.

One of the goals of quantitative easing in general and QE2 in particular was to stimulate spending via the wealth effect, the idea investors would harvest some of their portfolio gains and channel them into consumer spending. In other venues, this is derided as "trickle-down economics." Guess what? This has worked to a surprising extent. However, this makes the real economy vulnerable to any downturn in asset prices.

Stocks And Consumer Expectations

Both current consumer sentiment and expectation surveys fall into the category of an attitude and not a behavior. The University of Michigan's current sentiment index has been trending higher since the end of the financial crisis with the exception of the August 2011 reading linked to that month's stock market selloff and downgrade of the U.S. credit rating. However, the smoothed rate of change for retail sales has been trending lower for much of the past four years. I suppose it is better to be confident, but that does not necessarily translate into higher retail sales.

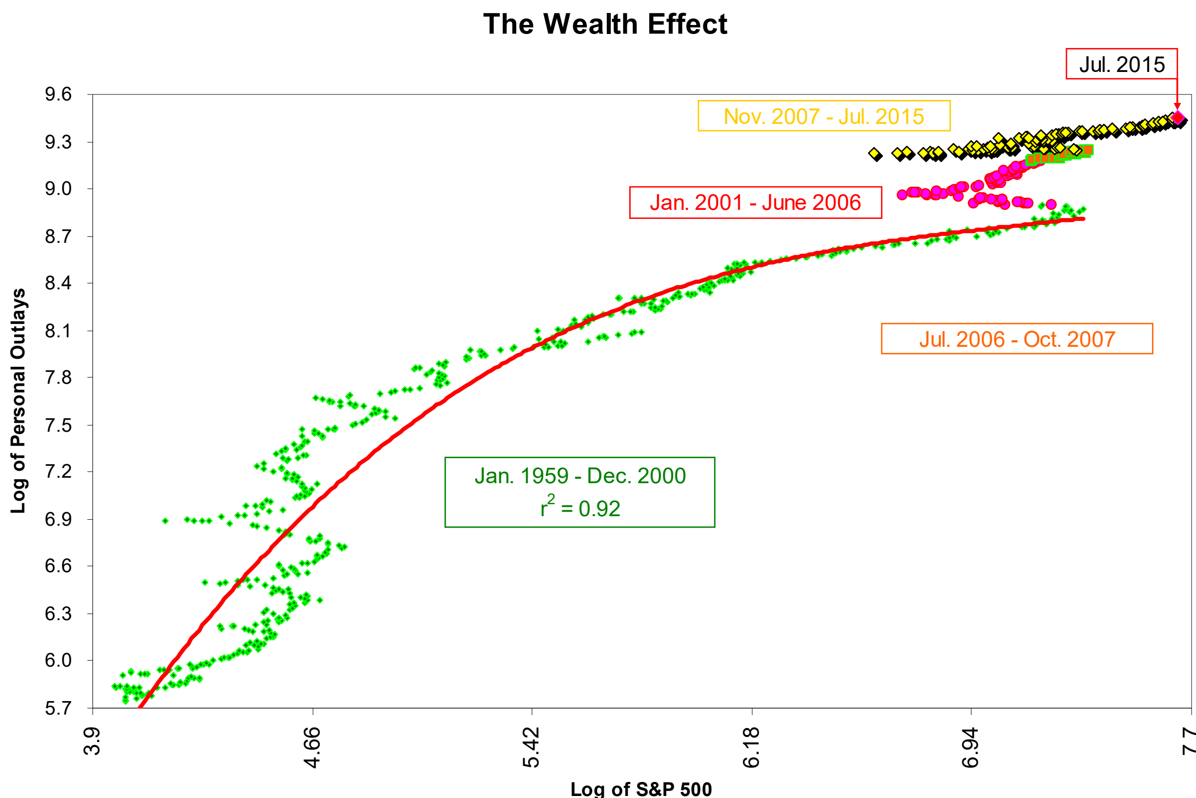
Now let's turn to the Michigan expectations survey. This index remains well over the downtrend extending all the way back to 1999 (trend channel superimposed) even though it has fallen since March 2015. Expectations have been a one-month lagging indicator of the rate of change in the stock market as measured by the S&P 500 for more than 35 years.



It took a long time for consumer expectations to react to the higher rate of change in equity valuations after the March 2009 low. This delayed response should not have been surprising as the gains in equities were concentrated within the upper quintile of the population. The present combination of downturn in expectations along with a downturn in the rate of change in stock prices has been a warning in several times in recent years, including in November 2000, April 2004 and July 2007.

Wealth Effect

What are the implications of a lower rate of change in equity prices for the wealth effect? 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, January 2001 – June 2006, July 2006 – October 2007 and November 2007 – July 2015. A red arrow points to the most recent datum.



Please note the strong linkage between personal outlays and stock prices prior to December 2000. The r-squared or percentage of variance explained here was 0.92. Anyone could be forgiven for assuming this relationship was a natural one.

If we concentrate on the post-November 2007 period, the beta of outlays as a function of the S&P 500 is only 0.25. However, the r-squared has been improving rapidly, increasing from 0.69 through February 2014 to 0.78 at the end of September 2014 to 0.81 in March 2015 to 0.84 at present.

This beta is not high by post-1959 standards, but the renewed strength in the relationship between equity valuations and personal outlays suggests any financial market downturn will have sudden and significant effect on personal outlays. While various FOMC members want to stop the short-term dependence of monetary policy on market gyrations, they will have to recognize what happens on Wall Street does not stay on Wall Street. Main Street will feel the wealth effect.