Relative Financial Stock Performance On Autopilot

There are fewer things more gratifying to an analyst than to see someone else come around to a conclusion you have held for years. I had such an experience last week when a prominent local economist looked at the path of the core personal consumption expenditure index and marveled how its trend has been immune to changes in monetary policy for more than two decades. I noted this most recently in late August.

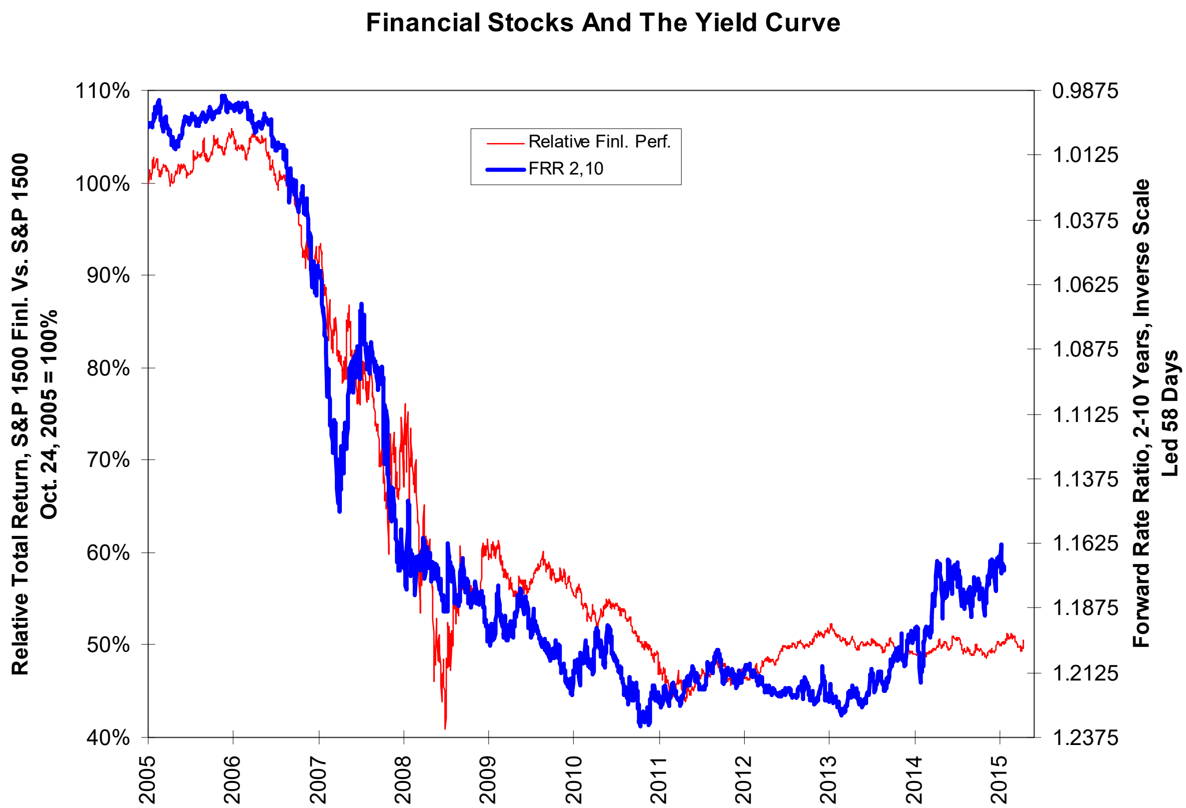
If core PCE, a concept most of us do not carry around in our heads as a mental calculator when comparing prices, has not been affected by monetary policy, what about the relative performance of financial stocks? Let's compare the total return of the S&P 1500 financial sector to the S&P 1500 Supercomposite itself starting from the October 24, 2005 date when Ben Bernanke was nominated to succeed Alan Greenspan. As the policies of the Yellen Federal Reserve have been a continuation of the Bernanke years, we can combine the two into a series nearly ten years long.

Relative To Yield Curve

Relative performance has been remarkably constant since expectations for U.S. short-term interest rates began shifting back and forth in March, ranging between 48.6% and 51.2%. It presently sits at 50.3%. This tight range suggests much of the chatter about financial stocks benefiting from a steep yield curve is uninformed.

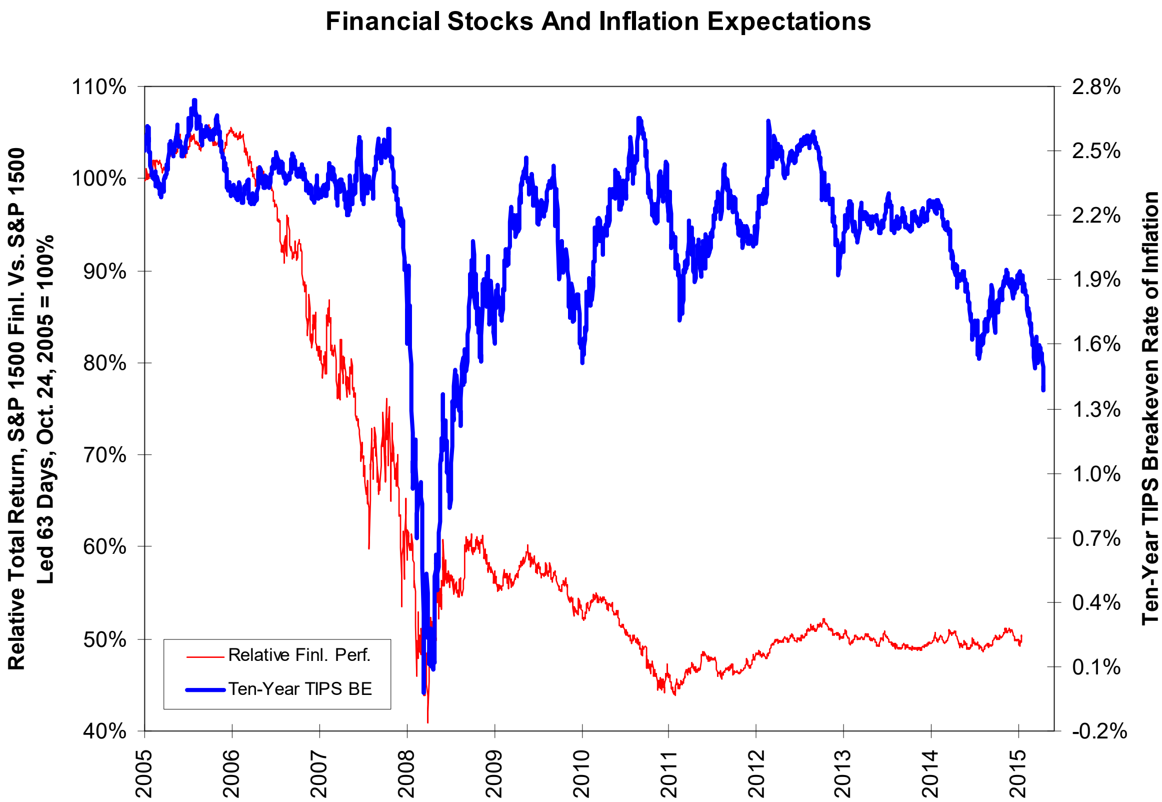
Let's map relative performance against the forward rate ratio between two- and ten-year Treasuries as a measure of the yield curve. This is the rate at which we can lock in borrowing for eight years starting two years from now divided by the ten-year rate itself. The steeper the yield curve, the more this ratio exceeds 1.00.

The Treasury yield curve as measured by the forward rate ratio between two and ten years flattened considerably since May 2013, from 1.223 to 1.173. Relative performance has not declined as a function of a flatter yield curve.



Relative To Inflation Expectations

What about relative performance as a function of inflation expectations as measured by ten-year TIPS breakevens? Breakevens have been collapsing since the end of June. As inflation tends to reward debtors at the expense of creditors, you might think the highly leveraged financial sector's relative performance would at least budge in response to these declining inflation expectations. No relationship exists.



So here we are, in a world of a flattening yield curve and declining long-term inflation expectations and we are being told to brace for a hike in short-term interest rates that will most likely perpetuate these two trends. Should you raise or lower your exposure to the financial sector in response? No, your best course of action is to do nothing, and that is always the toughest trade.