

# Equity and High Yield Risk and QE. Why is QE Not Working for the Real Economy But Inflating Assets?

Why is QE ineffective in reviving current demand and employment even as it drives up equity and high yield bond markets?

The massively expansionary monetary policies have yielded surprisingly low inflation while inflating asset prices across the globe. Bond yields have compressed and equity markets have surged in the past 5 years. Why is monetary policy ineffective at restoring normal levels of demand and employment? The answer is, because our specification of the set of prices over which monetary policy has domain is incomplete. Money can be spent on more things than just goods and services; it can be spent on claims on future goods and services. This is called saving, and saving is not consumption. A confluence of low interest rates, efforts to create inflation, expectations of high future inflation and efforts to flatten the term structure of interest rates have resulted in inflating the value of assets and not goods and services.

Under elevated inflation expectations, the rational response is to consume or to secure future consumption at today's price levels, to hedge against inflation with an appropriate hedge. Short term cash is not useful in this respect as its value will be eroded if prices start to rise. Neither is it practical to raise current consumption without bound or consideration to future purchasing power. Services are not durable goods. Notice the recovery in automobiles and other consumer durables? Durables are current and future consumption. Equities and real estate are considered inflation hedges and investors have rushed to buy them. The diversion of capital from current consumption to future consumption in the form of equity or real estate ownership is a rational response in this context. The suppression of the term structure of interest rates also means a lower discount rate for future claims to goods and services, further supporting the equity asset class.

What could derail the equity market therefore includes lower inflation expectations

or a steeper term structure.

We asked ourselves in mid March if equities and bonds were one correlated bet. If the above explanation for the strength of equities is valid, what might cause the equity market to lose its support? If the economy was truly strong, then the advent of QE tapering would recommend switching from high yield to equities. If not, and equities and bonds were a single bet then QE tapering could prove damaging for equities.

Under the same hypothesis, what would the government policy look like? Asset purchases across the term structure have not helped income and employment, so if the Fed comes to realize that the above behavioral thesis holds, then how is it to encourage consumption? A non interventionist approach would be to roll back QE and step away, but we see that this might adversely impact the equity market. The interventionist approach might be to tax and spend while maintaining a neutral budget (that is still in deficit but not more so). Taxing capital gains at higher and more progressive marginal rates would achieve this. The problem with more intervention is that it risks creating more distortions and perverse agent behavior.