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Bernanke's Wet Noodle

Don't fear a stock market slide if the Fed tapers its accommodative policies. The low interest rates from these policies may not be pumping up the stock market as much as one thinks.

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On June 19, when Ben Bernanke dared to tell the world the Federal Reserve might taper its quantitative easing, the media buzzed and the stock market shuddered. Never mind that he suggested such a shift would be neither immediate nor abrupt and would only occur after evidence of strong economic results.

What happened next? The total market capitalization of companies listed on US exchanges plummeted almost $2.5 trillion, or 5.4%, during the next four trading days. Many seem to have interpreted the Fed Chairman's comments as the bursting of what has become known as the Bernanke Bubble. Investors felt they had been beaten with a stick and everyone wondered how far the stock market would fall.

ANALYSIS

As it turned out, the fear was pretty short-lived. As of last Friday, less than a month after the announcement, the value of equities recovered all the lost ground plus an additional $636 billion. The reality may be that the stock market never baked in the low interest rates to begin with.

The reaction to Bernanke's comments is an example of how jittery investors have become. Investors seem nervous ever since the stock market surpassed the previous 2007 peak. Everyone seems to wonder if it is getting too high. No investor, large or small, wants to be caught over-exposed the next time the market collapses.

But is the stock market really high?

Back when the stock market last peaked on Oct. 9, 2007 the current members of the S&P 500 had average price-to-earnings multiples based on forward estimated earnings that were 9.2% higher than the same metric through Friday (July 12). And 63% of these companies have lower valuation multiples now than they did back then. (Note this excludes 45 companies that either had negative earnings in one period or the other, or didn't have Wall Street earnings estimates.)

Why are the valuation multiples lower? Often, experts attribute this to lower expected growth, reduced reinvestment, increased regulatory costs including healthcare and a general fear that the future economy may not be too strong, especially in some foreign countries which could dampen exports. Indeed these all have merit.

But another important contributing factor is that Ben Bernanke's low interest rates may have never actually been priced into the market. The financial theory would suggest that low interest rates should lead to higher valuations, but this is the opposite of what we are seeing.

Investors may have acted as if they knew, at least collectively if not individually, that the party would be end some day. Maybe investors did learn something during the Internet and real-estate crashes.

How could this have played out? Corporate net income is higher now due to the lower interest rates. If investors are anticipating that these low rates won't last forever, maybe they are valuing companies based on some lower earnings estimate -- acting as if interest rates were "more normal."

Indeed it wouldn't take much higher interest rates for net income to meaningfully drop when you consider these companies held over $7 trillion in debt at the end of 2012.

So despite all the hullaballoo about quantitative easing and the accommodative Federal Reserve policy, the stock market may never have actually embraced it.

Maybe this explains why these subsidizing Federal Reserve policies have done so little to spur us back to stronger growth. The whole idea of the accommodative policies is to make investments appear more attractive so investors will invest more. That is supposed to drive employment, demand and the overall rate of economic growth.

But if low interest rates don't spur investors to value assets higher, then how can we expect such policies to lead to more investment and higher growth?

There is another way to arrive at the same conclusion on the effectiveness of Bernanke's policies. Consider the hurdle rates most corporations use for making investments. The corporate finance text books dictate that a company should use its weighted average cost of capital (WACC) for debt and equity as its hurdle rate for making investments in their core business. Virtually every company calculates their WACC periodically and using the typical methodologies they have seen their WACC decrease as interest rates have declined.

Based on my work with numerous companies it seems few have brought their hurdle rates down as much as their calculated WACC has declined, as they too understand the Federal Reserve policies can change rapidly and on average over time interest rates are expected to be higher.

So Ben Bernanke's seemingly powerful affect on the stock market turns out to just be a wet noodle after all.

The more important problem that rising interest rates will create has nothing to do with companies or investors at all; it concerns the US government deficit. With almost $17 trillion in outstanding debt, every 1% rise in interest rates will increase the deficit by $170 billion. And remember the 10 year government interest rate peaked at over 9% in the early 1990s. Yikes!

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