Overview

2022 was all about getting Fed balance sheet down and the US Dollar up. 2023 in reverse is all about getting the US dollar down and the Fed balance sheet up. An interesting quote on Global Financial system that all of us should possibly memorize that came from BIS in May'22 which is the top operating authority, *"Central Banks should, in situations where it appears likely that market dysfunction will adversely impact the real economy, consider using their ability to expand their balance sheets and provide liquidity."* This is what has exactly happened over the past couple of weeks. Janet Yellen more or less gave guarantee against deposits in the entire US banking system. Broadly, we may end up holding Central bank digital currencies even before we realize.

This quote by Paul Volker from the 1984 FOMC meet after the failure of continental Illinois bank, could be more relevant today *"I think we're coming close to running out of maneuvering room…. I don't conclude…that any kind of easing signal is justified or appropriate. But I do conclude, given everything we know…including that for the moment the monetary aggregates look reasonably quiescent, that its not time to take a strong initiative in the restraining direction…I am not saying that there is no room for some tightening down the road if the momentum of the economy continues...".* Within a week from this statement rates came down by 50 bps. But the backdrop of economy back in 1980s was not similar to what we have now. That time the economy was pretty strong, had a lot of momentum, employment was strong, inflation was a nagging problem etc.

Liquidity cycle has bottomed and moving up from here. Based on rising global liquidity, major stock and bond markets could be range bound in 2023, but unlike 2022 some areas could enjoy strong absolute gains. Themes that could be in flavor are ones that benefit from weaker US $, China re-opening and stronger commodities.

Global Liquidity

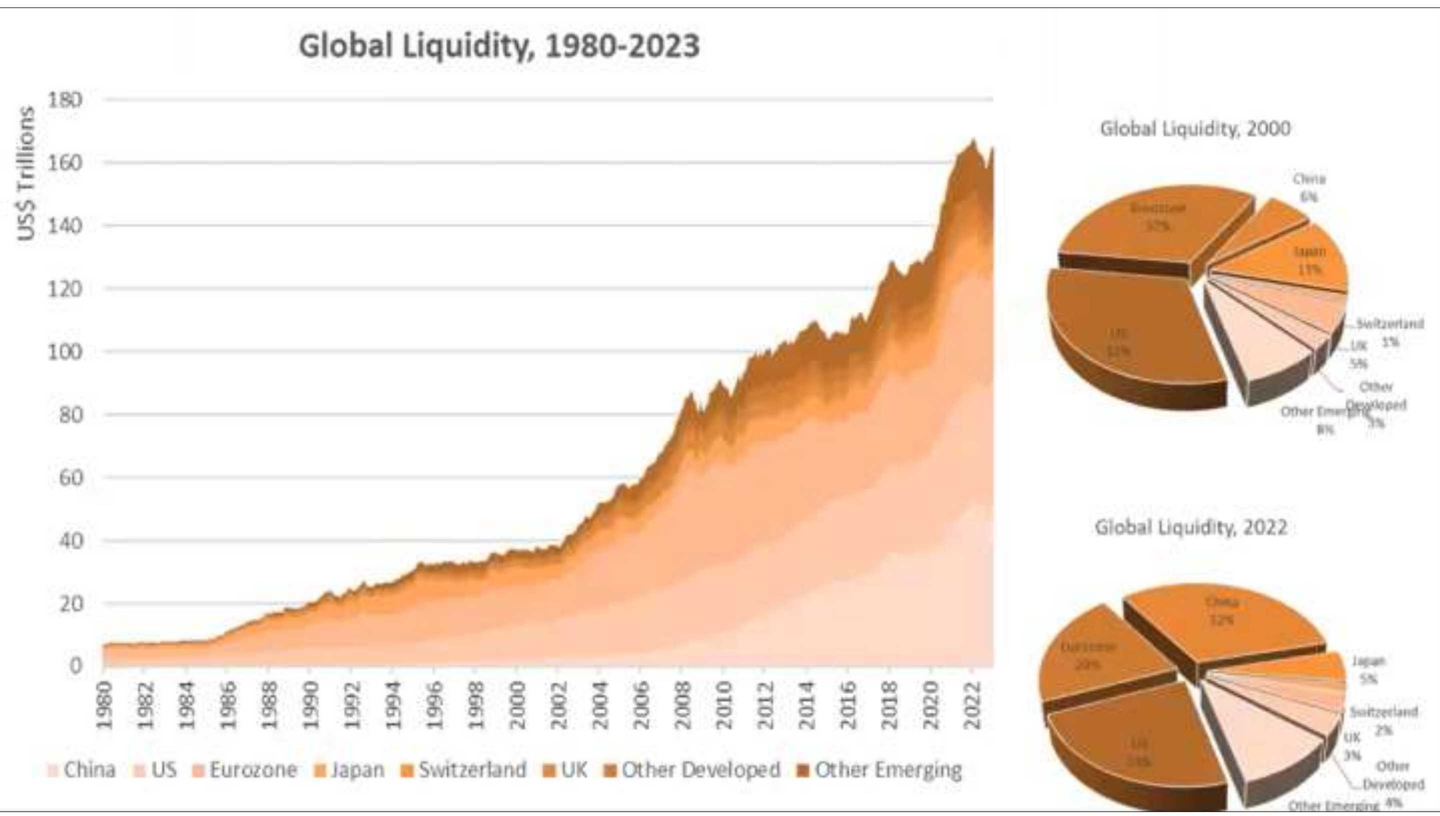
This is independent of world GDP and nearly twice the size of World GDP and since 1990s has driven world business cycle. Global liquidity stands at $170 trn; while, world GDP is at $100 trn. Global liquidity is a measure of balance sheet, i.e., the CAPACITY of capital not the cost of capital. This really matters when the debt has to be rolled over. The text book model of financial markets is liquidity is needed via capital markets whenever there is a new capex plan. Unfortunately, that's no longer the case. Refinancing of existing debt is much bigger driver of liquidity needs.

(Source: Michael Howell – Cross Border capital)

There is massive amount of debt in the global economy i.e., ~$350 trn with an average maturity of 5 years; which, on an average $70 trn of debt has to be rolled over each year. That refinancing needs is pressed on to the financial markets which basically needs liquidity to refinance. Unavailability of this leads to refinancing crises like seen in 2008, 2019, 2020 & 2023. Liquidity is absolutely essential for operation of a debt-ridden economy. Problem arises when this liquidity spills over to asset markets and causes inflation.

Global Liquidity is defined from the assets-side of credit provider's balance sheets. It comprises: (1) Central Bank interventions (2) bank and shadow bank credit, corporate cash flow, collateral-based wholesale and repo market activity and (3) net foreign flows i.e., liquidity is broader and more inclusive then just looking at M2 money supply. Think of it as essentially starting where conventional definitions of 'money' like retail bank deposits, stop. For example – US liquidity stands at $40trn which is much bigger than traditional liquidity measures like M3 (not published anymore) - $30 trn, M2 - $21 trn and M1 - $19 trn.

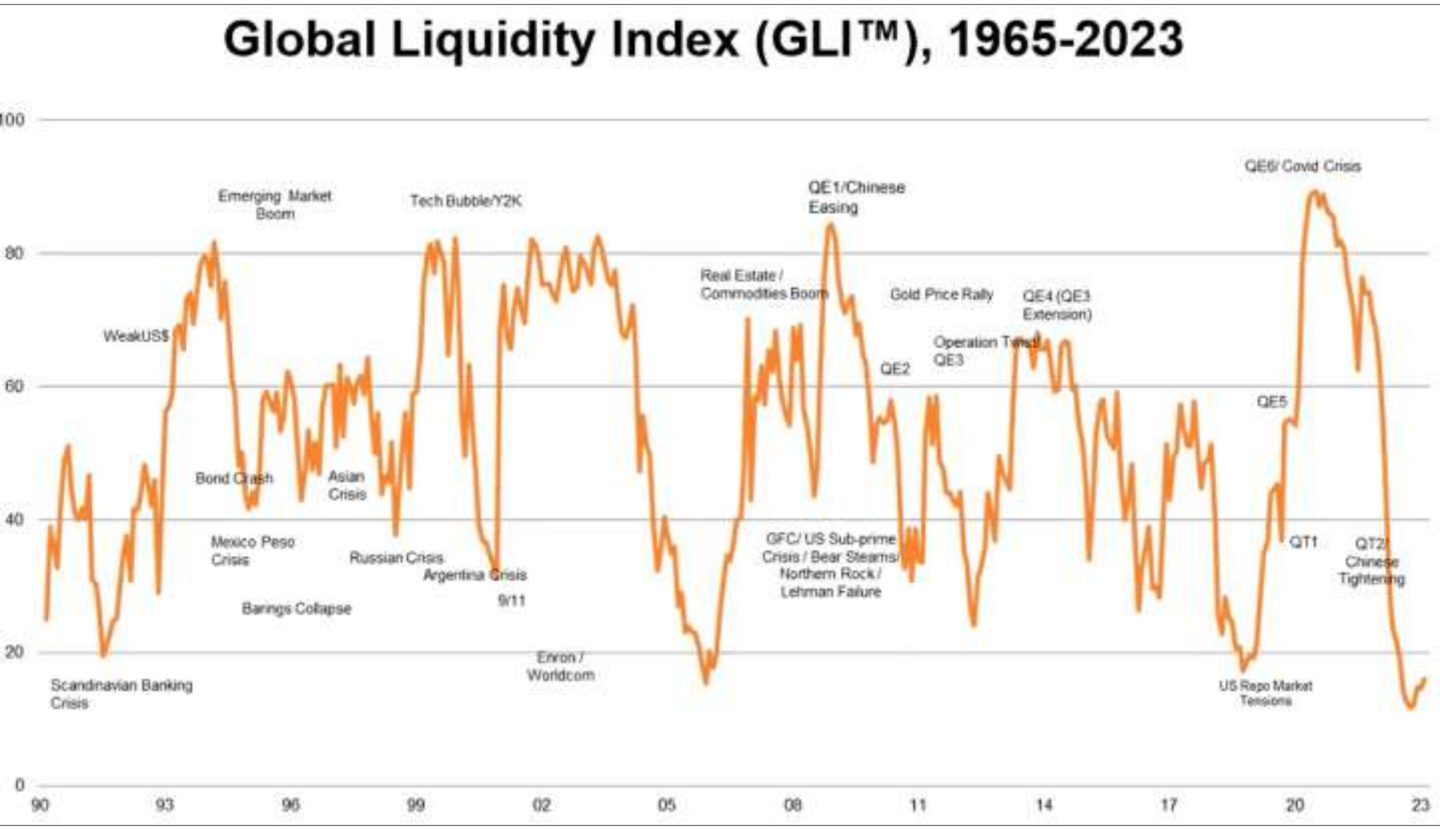
Regional Breakdown



(Source: Michael Howell – Cross Border capital)

Beyond US, global liquidity stands at $170 trn and is expandingly rapidly as seen in the spike up in the bar chart. The composition of this liquidity as depicted in the pie chart shows that, non US liquidity has escalated dramatically over past 20 years with China occupied a bigger component of this. This clearly represents a challenge to the financial stability in the system; because, China at the moment is very reliant on getting off the Dollar system of trade practice.

The movement of this liquidity or the growth rate of this liquidity is seen in the Global Liquidity Index graph below



At the peak of liquidity cycle you have asset market booms and at the low point in liquidity cycle you have banking failures or credit crises (exactly what we are seeing right now). Presently, we are at a low point in liquidity and this liquidity needs to and has started to move up.

(Source: Michael Howell – Cross Border capital)

The Liquidity Framework: Why Market P/Es make little sense?

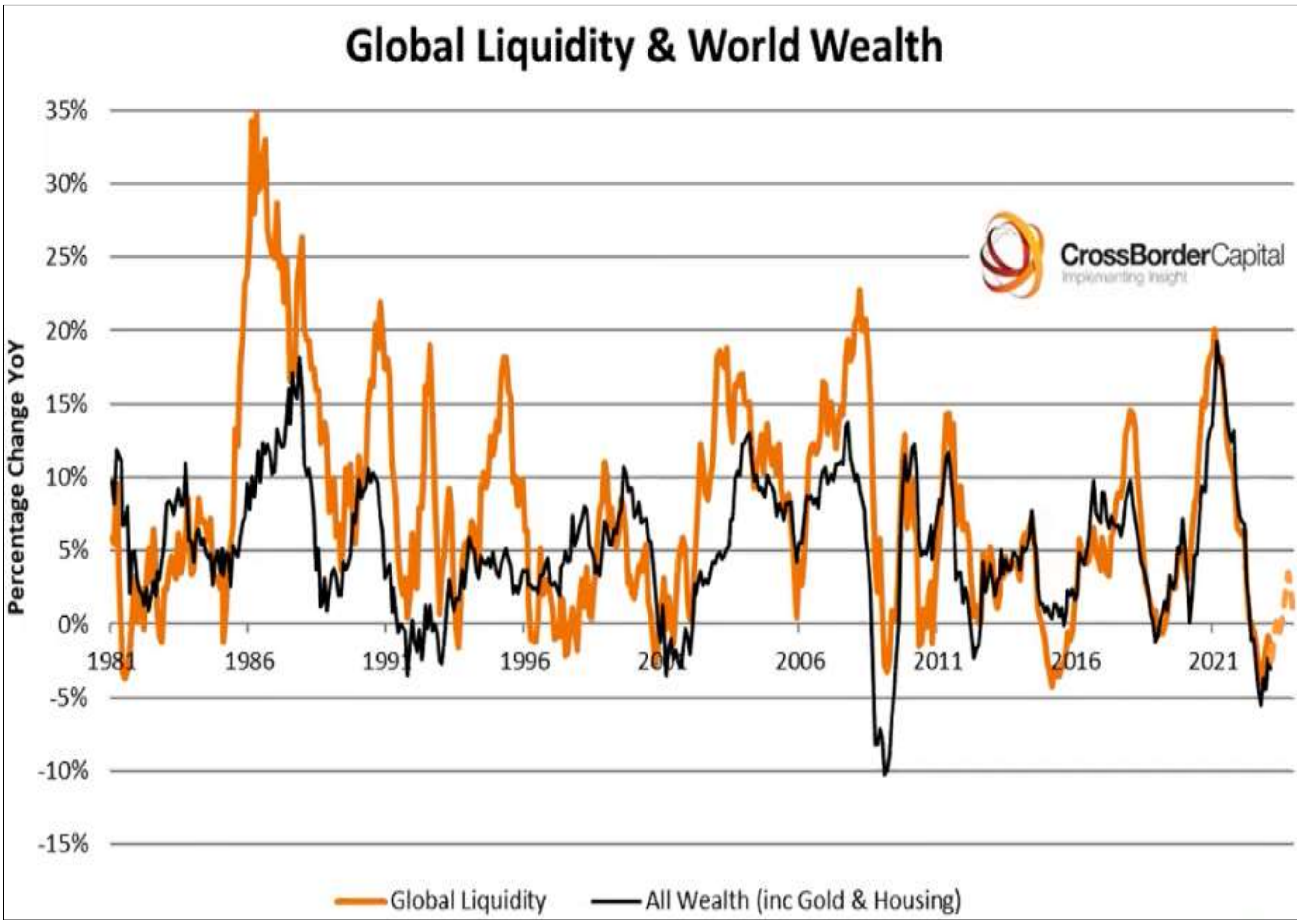
Essentially, when we think our liquidity, we tend to compare/align it to market valuation parameters typically P/E ratio. Anyone looking at macro analysis cannot use market P/E multiples to determine market liquidity. For ex – the Japanese market throughout the 1980s had P/E multiples well in excess of U.S; but, Japan outperformed dramatically over that time. And then, if you look at Europe or European area, their market P/Es have consistently below the U.S. for 3-4 decades atleast; but, U.S. markets have outperformed significantly.

P/E is driven by two other variables atleast i.e., market liquidity & GDP of the economy. P/E can go up if either of these two factors run up. Presently, both these factors are moving around quite significantly & that is what is causing valuation shifts. P/E do work at individual security level; but, at macro level its important to understand the drivers of P/E which is systematic liquidity and GDP.

This ratio of world equity to global liquidity averages at 0.5 and is mean reverting in nature. So, purely on this metric these valuations do not look that demanding right now.

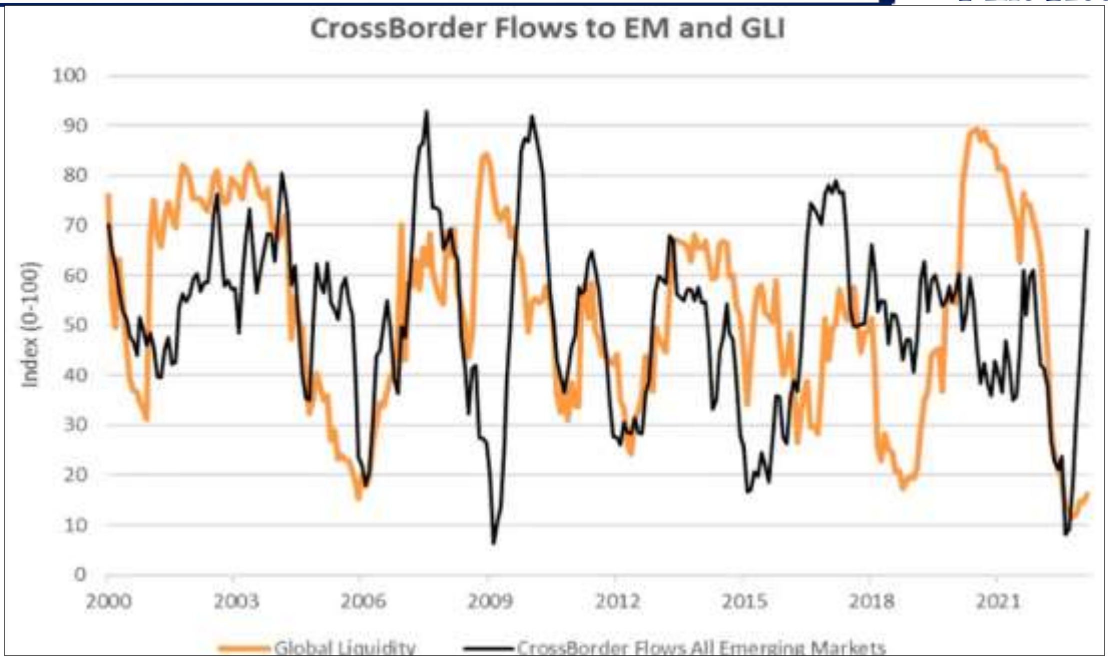
(Source: Michael Howell – Cross Border capital)

The chart below depicts the movement of Global liquidity vs. All wealth i.e., all assets including Equities, fixed income, gold and housing. The two factors while were lagging indicators have got increasing close over the last decade with the correlation moving from 0.6 to 0.8 in the last decade. The orange dotted line represents liquidity projections for the rest of the year. This possibly means risk investors probably have the wind behind them and may not continue to face the wrath of Central Bankers.



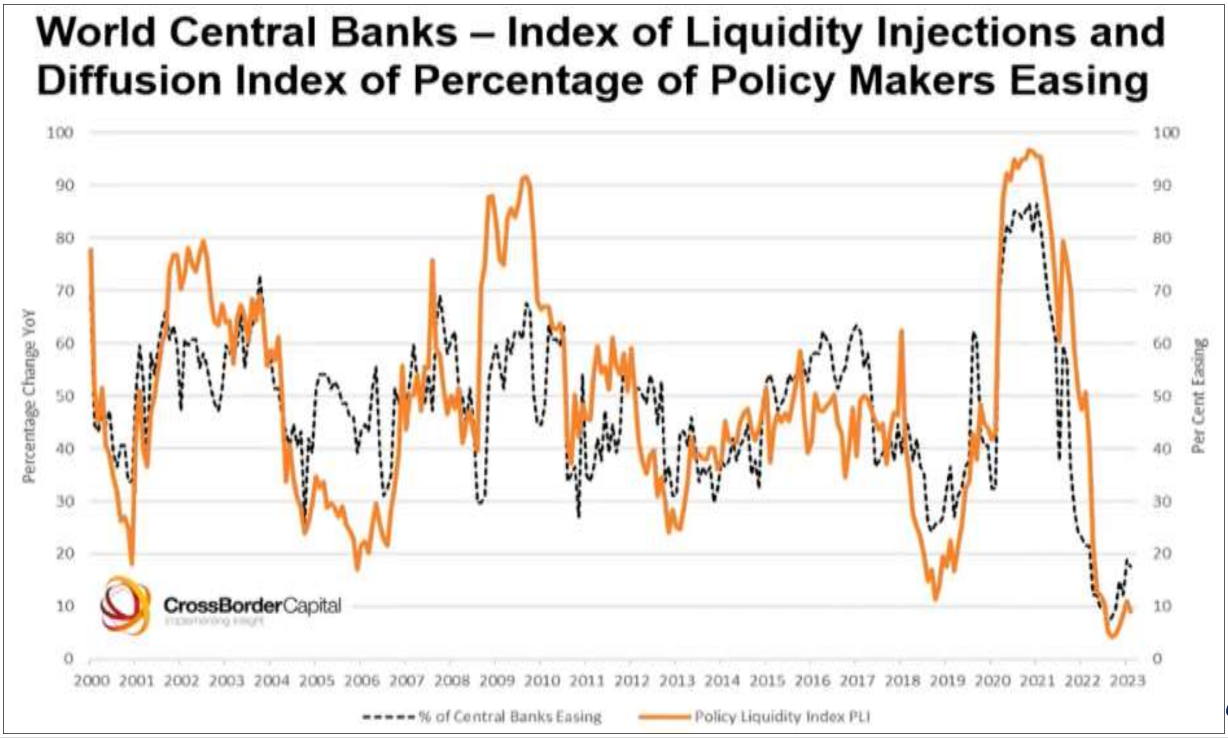
Cross border flows to EMs are often an indicator of Global liquidity cycle. In order words, the spike in flows to EMs probably tells us that the Global liquidity cycle has bottomed and is likely to be picking up.

(Source: Michael Howell – Cross Border capital)



What are the world Central Bankers doing?

Orange line depicts movement in Policy liquidity which is an essential part of Central Bank's balance sheet. Dotted line is the % of Central Banks worldwide that are easing in terms of liquidity injections. We hit the bottom about last October and we have been moving up gently since then. 20% of the 90 odd Central banks are currently easing/beginning to ease



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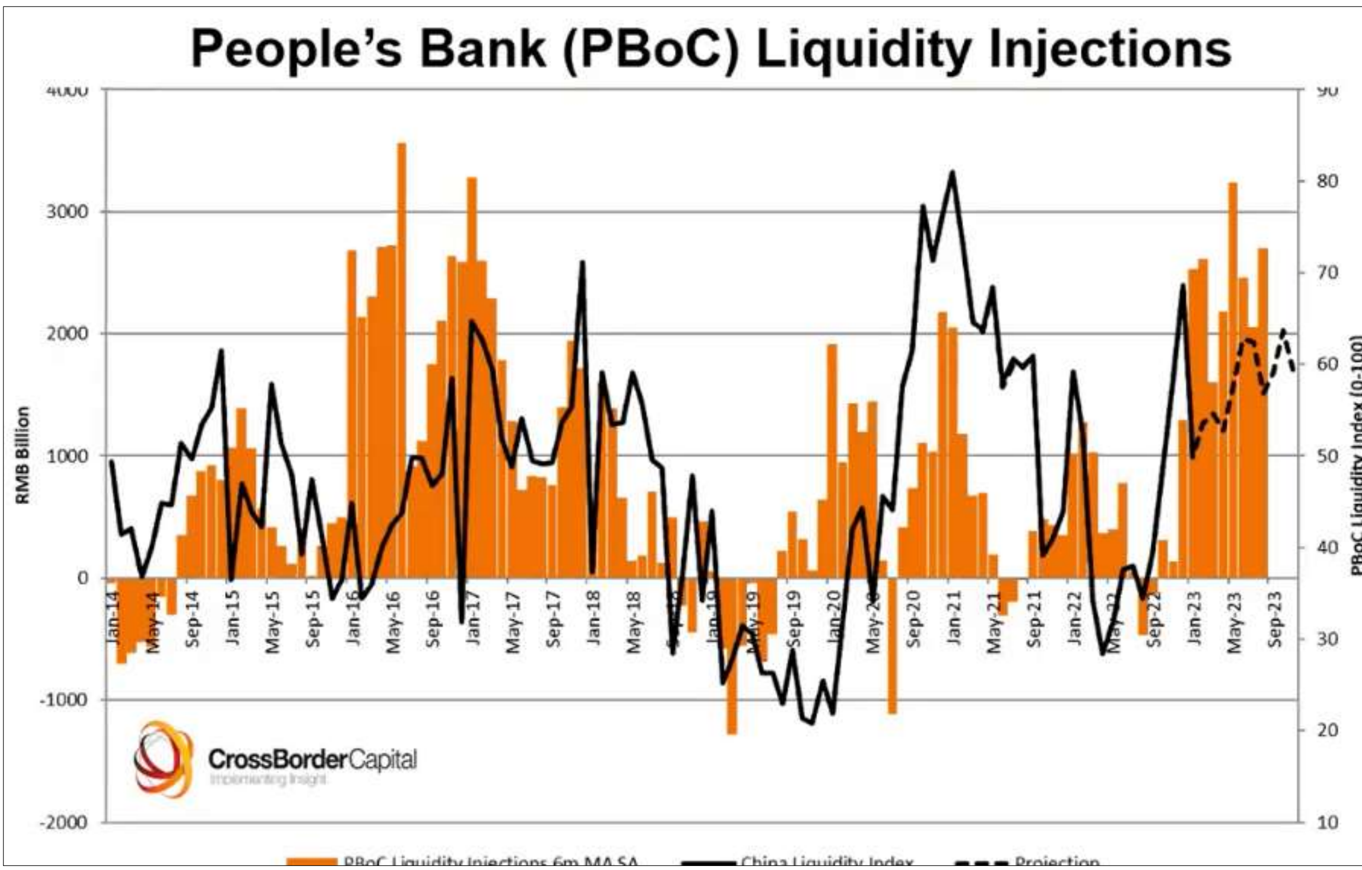
One of the Central Banks that is integral in this equation is PBOC. China is a huge player in Global financial markets in terms of liquidity creation.

In crude manner, if markets have two moving parts – P/E and E determining the valuation then Fed/the dollar system is driving the P/E i.e., the valuation of assets and China is driving E.

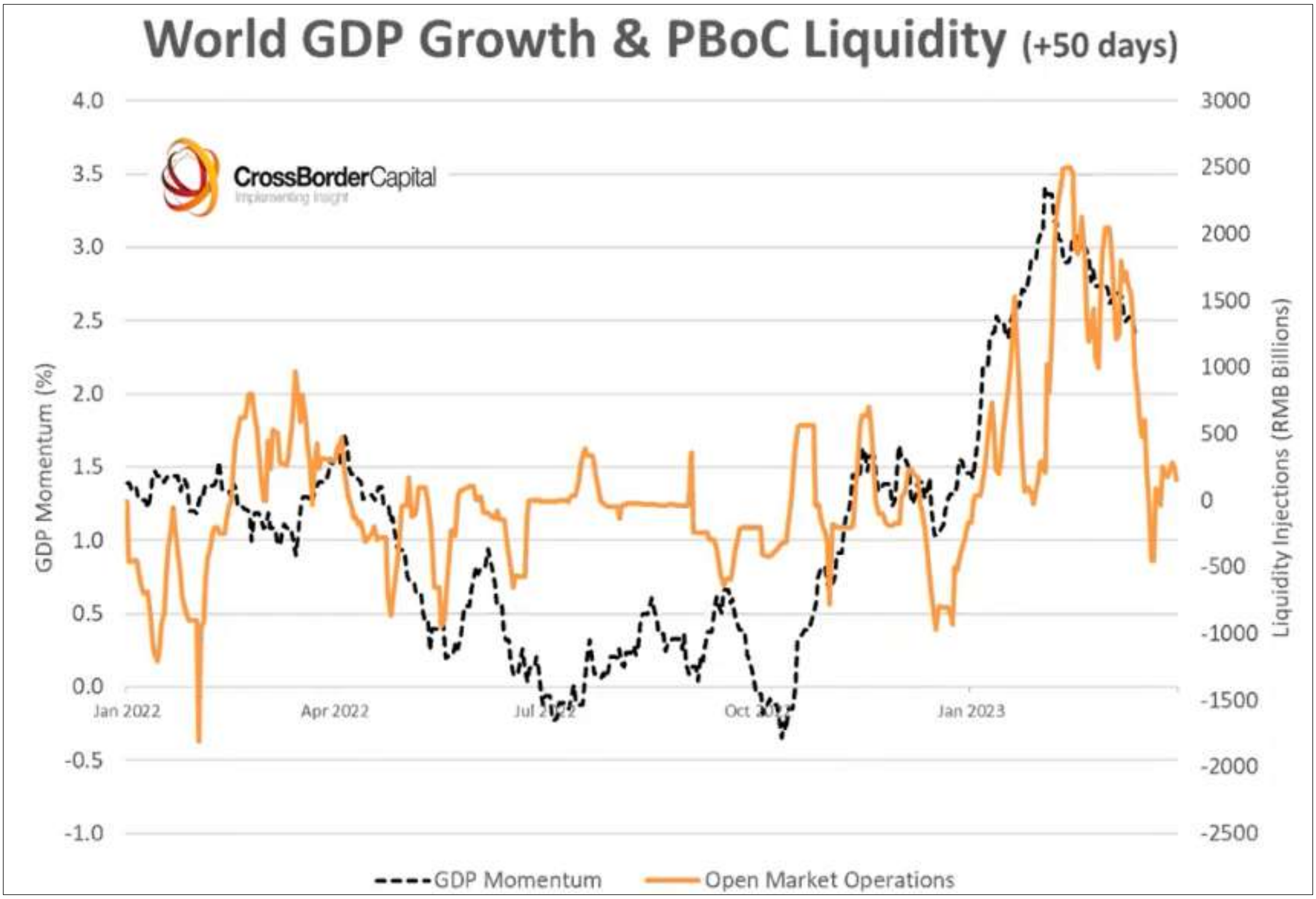
Orange bars are an indication of the amount of money injection by PBOC into their monetary system. Since Sept/Oct'22 there has been a substantial pace up in the liquidity injections by China. Extrapolating this into future its seems that liquidity conditions will continue to ease, maybe at a slower pace. So essentially, China which influences the 'E' is turning the monetary taps on.



What is the impact of this liquidity on world economy?

There seems to be a 50 day timeline between what's happening in the PBOC liquidity and impact thereof on the world economy. So if you got a lot of Chinese expansion going on then, even if there is world recession the impact thereof could be diluted.

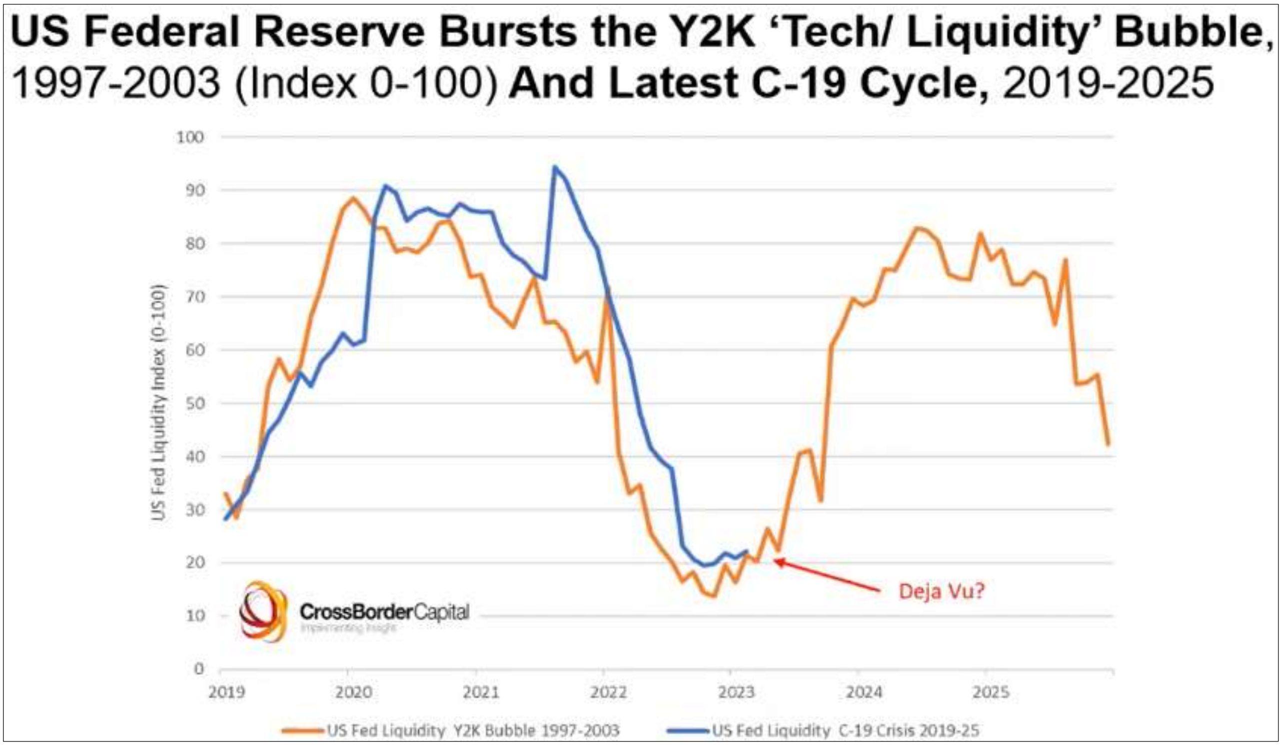
(Source: Michael Howell – Cross Border capital)



Looking at the current liquidity trends, we could witness a stronger world economy in the second half of this year. PBOC is critical to the health of Chinese economy and in turn the Chinese economy is the elephant in the room when it comes to the world economy. This is why its very important to understand what's happening in terms of monetary conditions in China.

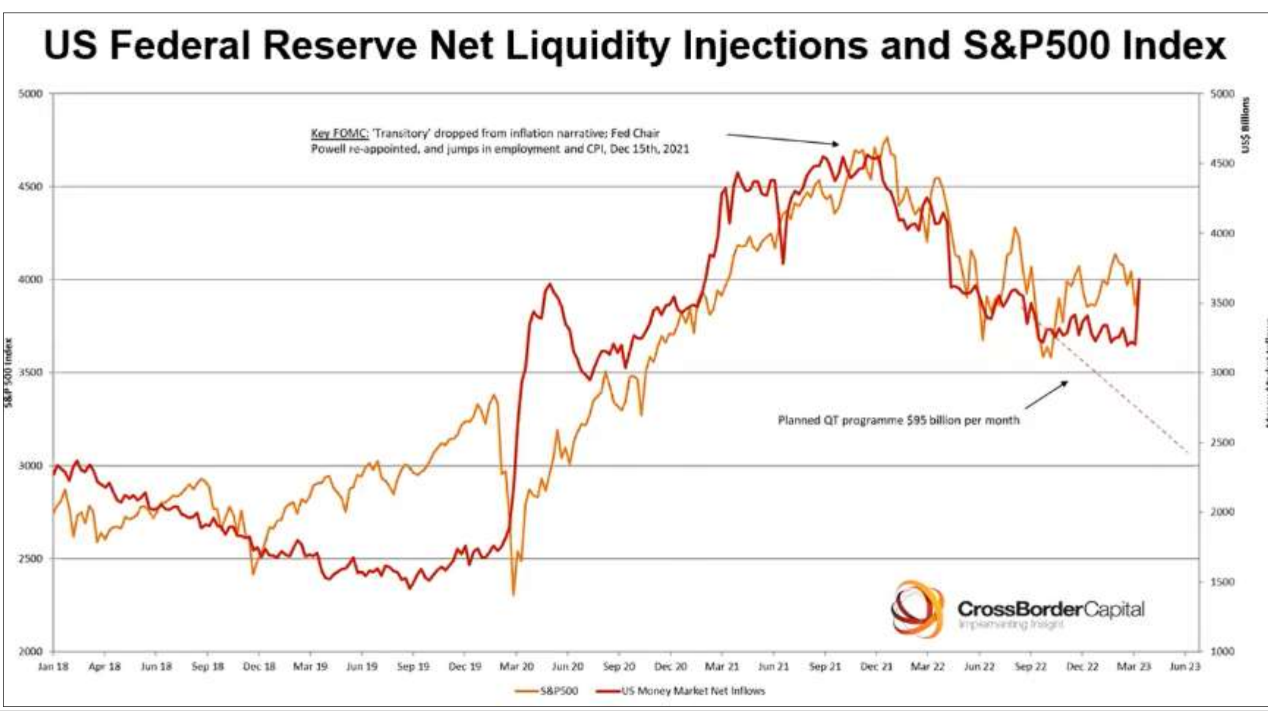
But, it's vital to understand what's happening with the most important Central bank, the Fed. The blue line is the movement in Fed liquidity injections in this cycle. The orange line is exactly what happened in the Y2K bubble cycle from 1997-2003. If we see repeat of the past and are effectively at 2001-02 levels then it would signify that liquidity is coming back and we could see traction coming back to asset markets. It was credit markets that performed pretty well as liquidity came back to the system.

(Source: Michael Howell – Cross Border capital)



This chart talks about the impact of Fed liquidity in the U.S. Equity markets. Since Dec-21, the descend in liquidity has led to market corrections.

The dotted line represents planned QT original targeted by Fed. As can be seen clearly, there surely happens to be some re-thinking as present levels are ~$1trn above the targeted levels.



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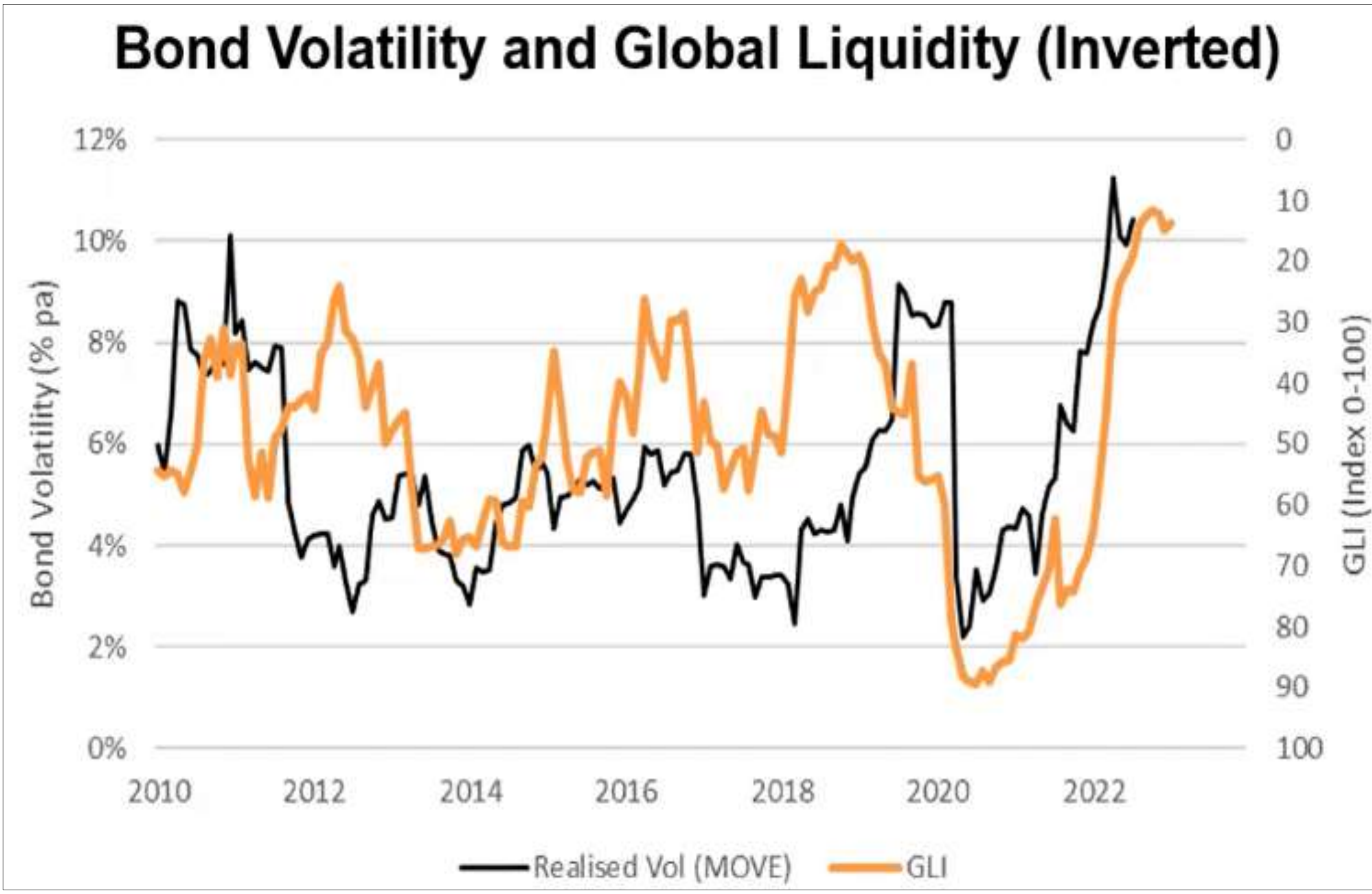
Key Takeaways –

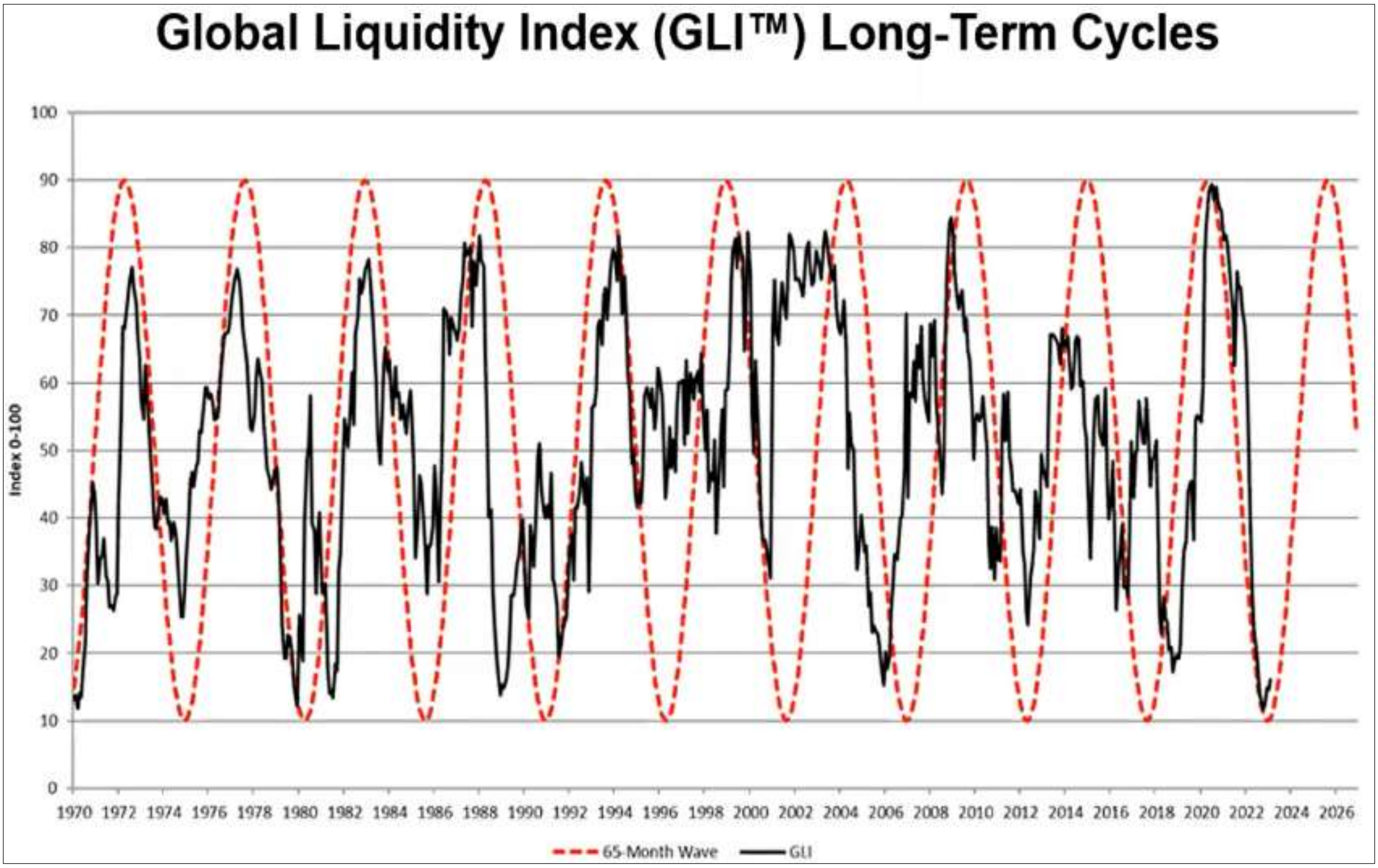
Stop looking at VIX, look at MOVE Index



Bond volatility and Global liquidity are closely connected. So key takeaway here is don't look at the VIX for market liquidity, look at MOVE Index to gauge the health of financial system going forward.

Key Takeaways –

Where are we in the Global liquidity cycle – peak or trough?



This is a cycle going back to 1970s and presently suggests that we are at a trough and most likely we will move to another peak in 2025-26 and that will have ramifications for asset markets. Commodities and Equity markets may do quite well in this run up and Fixed Income markets could be in doldrums because they are increasingly being manipulated by the governments.

(Source: Michael Howell – Cross Border capital)

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