FT FINANCIAL TIMES

Authers’ Note: Markets like the juice

How should we prepare for a world when liquidity stops growing?

By John Authers
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Markets live on liquidity. And that has helped them for a while. How should we prepare for a world when liquidity stops growing or even starts to shrink?

We need to be careful with definitions. Depending on the context, liquidity can refer to cash on hand, or it can refer to a line of credit, or it can mean the willingness of traders to make a market in a scarcely traded security. For now, I want to look at broad financial market liquidity, which is generally defined by the relationship between growth in M2 (a broad measure of the money supply) and the growth in the economy. When the supply of money is growing faster than the economy, the excess money is not invested in people, plant or equipment, but tends to find its way into asset markets, pushing up their prices.

Thus expanding liquidity tends to translate into positive equity performance. This chart is from Atul Lele of Deltec. He defines excess liquidity as the growth in M2 divided by the growth in industrial production and adjusted for inflation. The relationship is strong, and suggests slower

equity growth in the near future.

Meanwhile Jim Paulsen of Leuthold, using a simpler measure of six-month growth rates in M2 and GDP, finds that the two lines have just met. With the Federal Reserve appearing set on tightening conditions somewhat, it looks a good bet that in the US liquidity will grow more slowly than the economy.

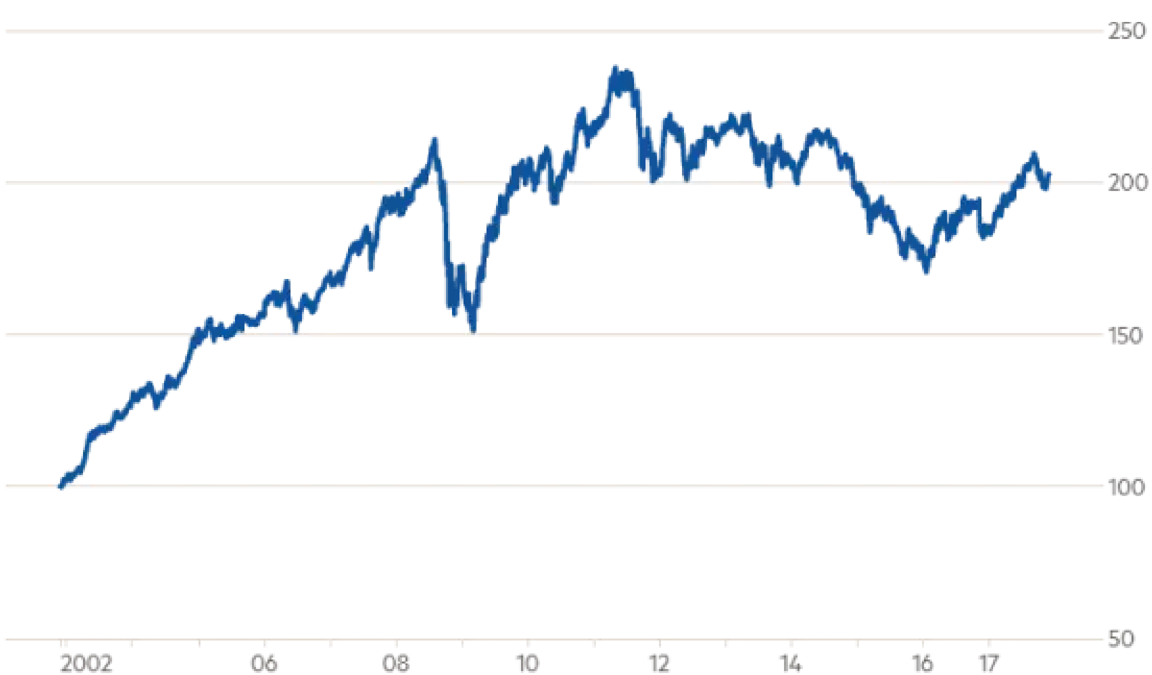
Jim shows, as might be expected, that when liquidity is declining, we can expect equity returns that are well below average, while bond yields rise.

Atul suggests that liquidity will be a problem in the new year:

> ***When global excess liquidity growth deviates from trend, asset prices respond. The reduction already seen in global excess liquidity growth will weigh on risk assets over the coming year. Risk appetite is currently above the level implied by liquidity conditions, and may roll over into 2018.***

So what should we do to prepare for tighter liquidity? One of the more obvious places to take profits would be in carry trade currencies, in which investors park money that has been borrowed in lower yielding currencies. There was an almighty carry trade crash in 2008, but in recent years, with developed world rates anchored at such low levels, it has been a reliable earner. This is a Bloomberg index that shows the cumulative returns from a basket of eight emerging market currencies:

Bloomberg Emerging Market 8-currency index

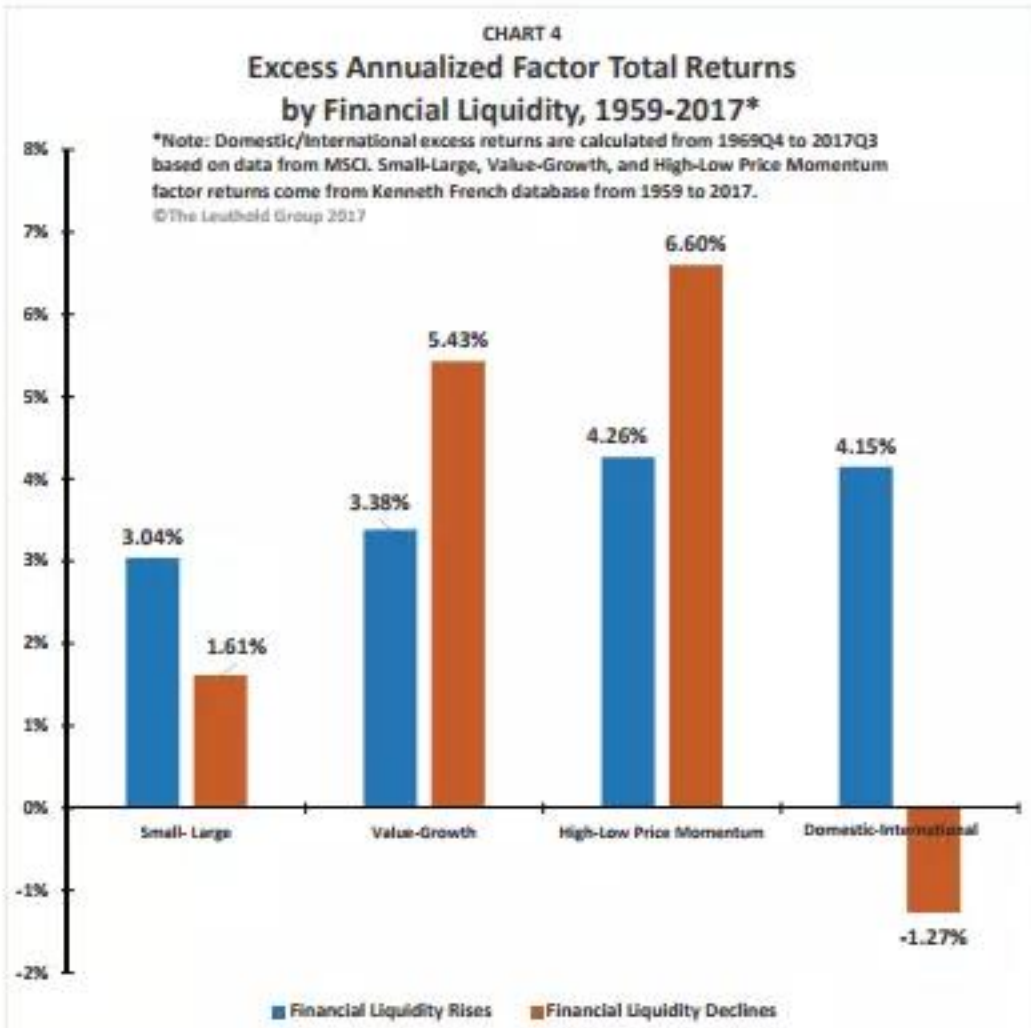


Source: Bloomberg

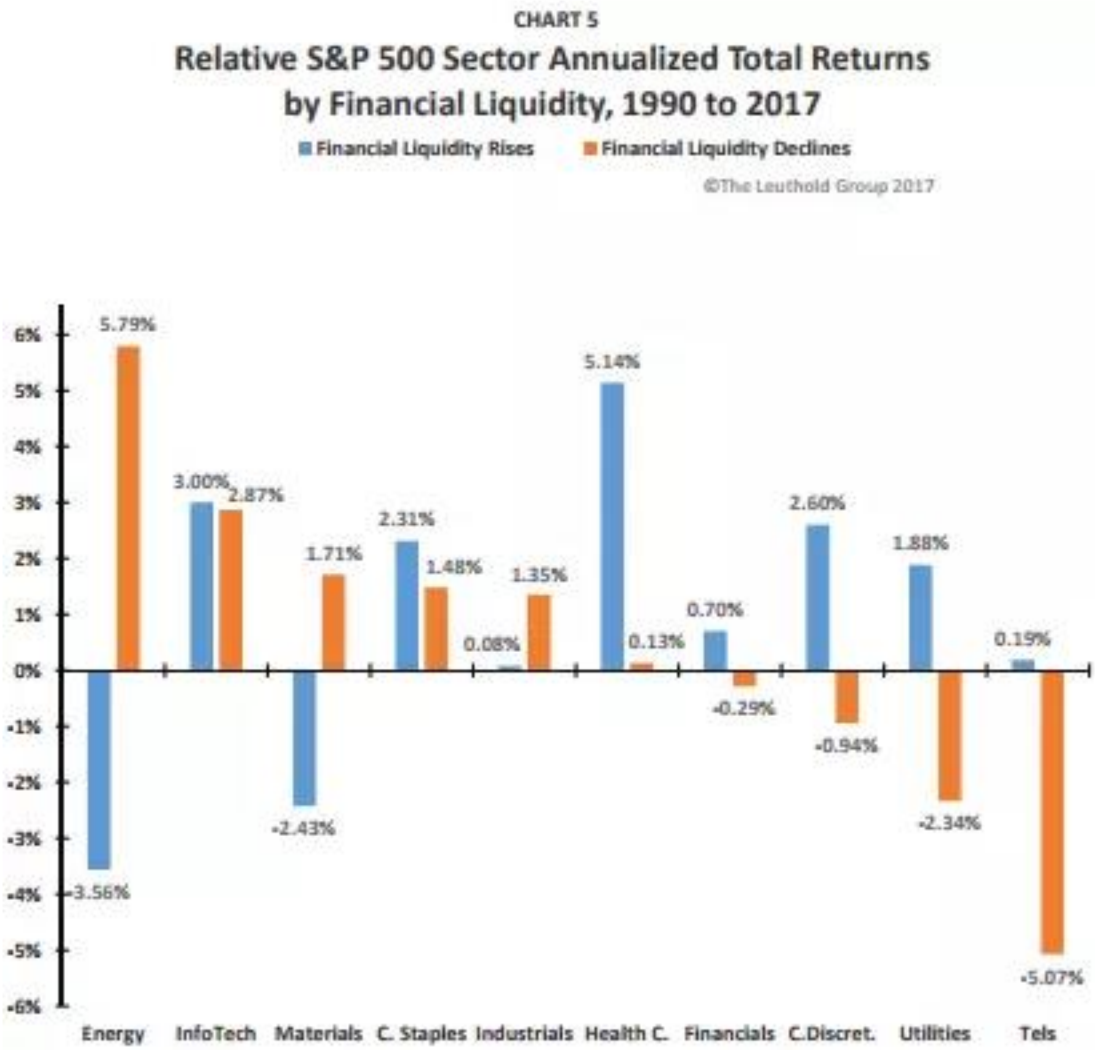
If liquidity conditions tighten as it is reasonable to expect, it might be an idea to exit from carry trades. As Atul puts it:

> ***Whilst there is the potential for a broad based decline in asset prices as liquidity growth slows, it will primarily impact carry trade and interest rate sensitive assets, given economic growth remains strong and will support growth sensitive assets. This momentum environment sees selective long and short opportunities across asset classes, particularly given the disparity at a regional and sector level.***

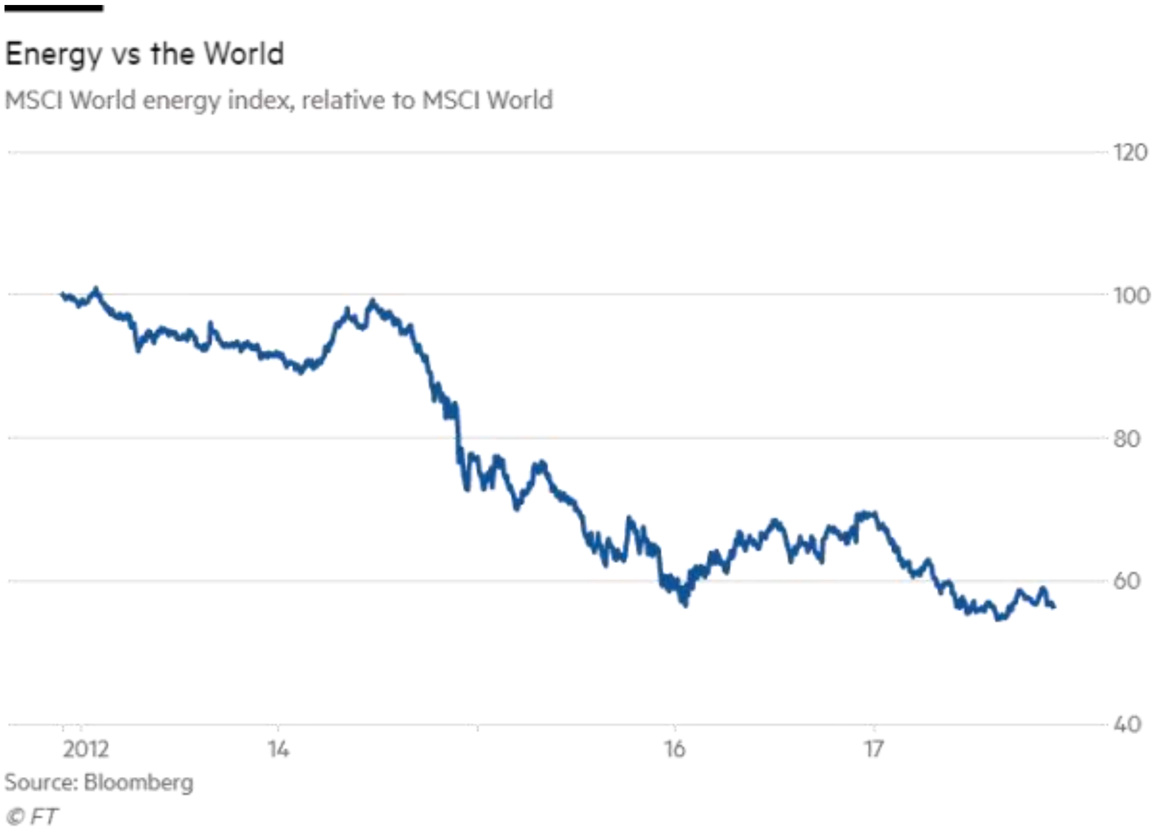
Beyond carry plays, what else tends to work? This chart from Jim Paulsen shows that the clearest message from recent history is to prefer non-US assets over the US. The fact that other central banks are behind the Fed in tightening should underline this message:



Other effects are far from clear, particularly as the distinctions between value and growth are growing muddied. Both momentum (which has had a great year) and value (which has had a terrible one) tend to perform slightly better amid reducing liquidity, but it is difficult to put much weight on it. However, the battering received by rate-sensitive stocks when liquidity recedes suggests that this might be a good time to leave sectors that have functioned as "bond substitutes" in recent years, like telecoms, real estate and utilities (none of which have had a great time of late), while the clearest likely winner is energy:



A further kicker for energy is that it has been a dreadful laggard for a while, by far the worst performer since the crisis:



I discussed this with Jim in a Facebook Live interview on Tuesday. I think it is worth a look:

This is Jim's peroration from his note earlier this month. He likens liquidity to "juice":

> *This bull market has been driven by several persistent themes including chronic investor fear, disinflation, falling yields, Fed accommodation, and yes, Juice! The pillars of this bull market are waning and the sand under investors' feet is*

shifting. Fear has morphed into cautiousness, inflation is still low but is no longer falling, yields probably reached a cycle low more than a year ago, the Fed is now tightening on a regular schedule, and financial liquidity has been contracting in the last six months! As financial markets are weaned off the juice they have been drinking for almost a decade, investors should prepare for a very different bull market in the balance of this recovery.

Without a chronic injection of financial liquidity, the stock market may struggle more frequently, overall returns are likely to be far lower, and bond yields may customarily rise. Moreover, as the juice is taken away, expect new investment leadership. Perhaps value investing will come into vogue, momentum investing may finally show some momentum, and international stocks may lead the rest of the bull market. Finally, it may be a good time to rethink some sector bets leaning increasingly toward those sectors which can prosper without much juice!

That juice analogy reminds me of something. It looks like markets really like the juice . . .

A Dennis Moore Tax Plan

US stocks had a good day on Tuesday — particularly financials. Jay Powell's strong response to Senator Elizabeth Warren that bank regulations were already tough enough reassured investors in bank stocks. Whether it should reassure the rest of us that banking regulation will be in good hands at the Fed is a much bigger question. Later, the alarming news that North Korea had fired another missile over Japan was soon forgotten amid the excitement that the Senate finance committee had managed to agree to the latest tax reform proposal, on a party-line vote.

Big cuts in corporate tax would automatically be good for share prices, as they mean that shareholders get to hold on to a bigger proportion of earnings — although much of that gain may by now be priced in. But would the proposals currently under consideration really be good news for the economy, or society at large, in the longer run? The last presidential election was in many ways an anguished howl against inequality and the way that a large chunk of the American population had been left behind. So this analysis by the Congressional Budget Office of the likely effects of the tax plan on different income groups makes for startling reading:

Allocation of Changes in Net Federal Revenues and Spending Under the Tax Cuts and Jobs Act

Millions of Dollars

Income Category	2019	2021	2023	2025	2027
Less than $10,000	1,540	5,870	7,440	8,680	10,070
$10,000 to $20,000	960	9,050	11,400	12,180	16,060
$20,000 to $30,000	80	9,000	10,200	12,210	16,720
$30,000 to $40,000	-3,920	770	2,440	2,560	7,610
$40,000 to $50,000	-6,040	-2,660	-1,800	-1,530	5,270
$50,000 to $75,000	-22,270	-19,470	-16,940	-17,380	3,980
$75,000 to $100,000	-21,520	-21,260	-18,470	-19,540	-1,390
$100,000 to $200,000	-64,240	-63,990	-52,900	-55,470	-5,340
$200,000 to $500,000	-59,570	-60,110	-50,010	-54,530	-5,190
$500,000 to $1,000,000	-24,880	-24,080	-18,690	-20,000	-1,940
$1,000,000 and over	-34,100	-28,690	-13,100	-15,810	-5,780
Total, All Taxpayers	**-233,950**	**-195,570**	**-140,400**	**-148,620**	**40,110**

Source: Staff of the Joint Committee on Taxation and the Congressional Budget Office.

Amounts are for calendar years and exclude effects of several provisions, including doubling the exemption allowed under estate and gift taxes.

Components do not add to totals due to rounding.

A decrease in federal deficits, such as an increase in taxes or a decrease in spending, is shown as a positive value. An increase in federal deficits is shown as a negative value.

It is about as directly regressive as it is possible to imagine — the polar opposite of what the electorate appeared to choose. There is always the argument from "supply side" or "trickle down" economics that the corporate tax cuts will stimulate growth, as Sam Fleming pointed out on Tuesday. But this seems a very big, expensive way to try to do it, and it is hard to see the evidence that cuts from already relatively low rates will have much of a stimulative effect.

On its face, passing this tax bill could either have terrifying consequences, as Martin Wolf thundered last week, or it could degenerate into absurdity. The latter might be preferable. To borrow from Monty Python, this could be a Dennis Moore tax cut: