The Exit From A Liquidity Squeeze

Louis-Vincent Gave
lgave@gavekal.com

If it walks like a duck and quacks like a duck, then it probably is a duck. By the same token, if central bank reserves are shrinking, the US dollar is rising, and emerging market currencies are cratering, we probably face a liquidity squeeze (see **Towards A Global Liquidity Crisis?**). None of this should be surprising given that the Federal Reserve is tightening policy, the US budget deficit is growing, the oil price is rising and US corporates are repatriating dollars held abroad and embarking on huge share buybacks. In short, the drains on US dollar liquidity have come from all directions this year.

Assuming that current market behavior—with all major asset classes outside of US equities underperforming cash since late January—is a symptom of an unfolding liquidity squeeze, the next question is: what stops the rot? I can see several exits although (spoiler alert) none yet seem to be coming into view.

In recent decades the Federal Reserve has tended to respond to economic crises even when the US has not been involved—that may not happen this time

1) **The Fed re-injects liquidity.** In recent decades, this is how liquidity squeezes have usually ended. Crises such as those that befell Asia in 1997-98 or Europe in 2011-12 may have had little to do with the US, but once markets started to worry and price in much weaker global growth, the Fed stepped in to provide liquidity for everyone. A repeat exercise seems unlikely today. Fed Governor Jay Powell has been vocal about wanting to tighten monetary policy and it seems unlikely that the Fed will change course without (i) a serious deterioration in US economic data, or (ii) a crisis that engulfs more than perennial losers like Argentina or Turkey.

A fall in the oil price has been a simple cure for a liquidity squeeze

2) **The oil price collapses.** The main reason most countries keep reserves in US dollars is that most countries are oil importers, and oil is priced in dollars. Thus, the higher the price of oil, the greater the need for dollars in non-oil producing countries, and *vice versa*. Hence, liquidity squeezes have tended to coincide with a collapsing oil price. Alas, today the oil price seems to be fairly steady in the US$65-75 a barrel range. This might

Checking The Boxes

Our short take on the latest news

Fact	Consensus belief	Our reaction
US nonfarm payrolls rose 201k MoM in Aug, from 147k in Jul; avg hourly earnings rose 2.9%	Both higher than 190k & 2.7% expected respectively; wage growth at cycle high	Tight labor market continues to push up wage growth; expect gradual rise in US inflation
German trade balance fell to €16.5bn in Jul, from €21.8bn in Jun	Below €19.5bn exp.; exports fell -0.9% MoM, from 0.0%; imports rose 2.8%, from 1.2%	Domestic demand supporting economy as weakening global trade weighs on production
China trade surplus at US$27.9bn in Aug, down from US$28.1bn in Jul	Below US$31bn expected; exports up 9.8 YoY, from 12.2%; imports up 20% YoY, from 27.3%	Record trade surplus with US as exporters front-load orders before new tariffs take effect
China' s CPI rose 2.3% YoY in Aug, from 2.1% in Jul; PPI rose 4.1%, from 4.6%	Both higher than 2.1% and 4.0% expected respectively	Inflation beats expectation but still well contained at manage-able levels

change, but given renewed sanctions on Iran, Venezuela's implosion and limited capital spending on energy since the 2015-16 oil price collapse, a sharp drop in the oil price doesn't seem to be in the immediate cards.

China has become the big gorilla that has been the final supplier of fresh global demand...

3) **China stimulates.** In 2008-09 and again in 2015-16, the world economy was stabilized by China doing massive fiscal and monetary policy stimulus. In the "old days" the world may have relied on the US consumer to be the "consumer of last resort" but recent rebounds in global growth have been spurred by the Chinese government. In both 2008-09 and 2015-16, we saw Beijing kick-start a new real estate cycle, along with a new infrastructure spending cycle. And, through a rising iron ore price, or rising coal imports, or rising soybean prices, China's actions helped the likes of Brazil, Indonesia and South Africa find their footing.

...today, China seems more focused on preparing for a trade conflict with the US

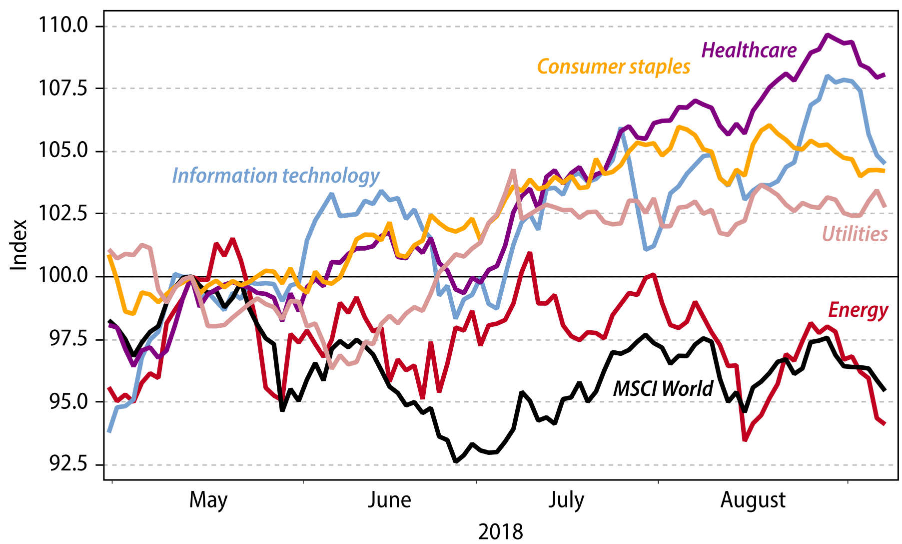
Today, a new wave of Chinese stimulus seems unlikely. Not because China can't afford to stimulate again, but because President Xi Jinping and his administration have been fairly vocal on the need for China to deleverage and stop throwing good money after bad debt. So turning around and stimulating now would do little for Xi Jinping's economic policy credibility. More importantly, China's leaders most likely feel that the country needs to brace for a potentially drawn-out economic conflict with the US. And until China has more visibility on the unfolding trade war, the best thing is to adopt a "wait and see" attitude.

Thus, it is hard to see near-term relief for the current liquidity squeeze coming through familiar mechanisms. Perhaps this explains why defensive sectors such as healthcare, staples and even utilities have lately started to outperform.

More defensive equity sectors have started to outperform

A surprising set of new leaders

MSCI World sector performance since May 14th 2018



Gavekal Data/Macrobond