Warsh Versus The Markets

By end-August, the direction of the investment cycle should be clearer. By then, Fed Chair Warsh will have delivered his Jackson Hole speech, which is likely to shape future Fed policy and confirm that further tightening lies ahead. Washington is currently fighting the tape, slowing the US Treasury market's adjustment. The central problem is that **world bond markets are adjusting to rapid nominal growth faster than policy frameworks can adapt.** Complicating matters, month-end will also bring another noisy July CPI print, further evidence of ongoing PBoC reflation, and the November US mid-terms will be barely 10 weeks away.

Main Points

- **Global Liquidity has peaked and is now weakening**, signalling a late-cycle shift from "Speculation" toward greater volatility and a more defensive investment regime. Liquidity is being pulled from financial markets into the real economy as activity and inflation pressures strengthen
- **Policy is increasingly constrained by bond markets**, with governments relying more on short-end issuance, buybacks, and money-market liquidity to contain long-term yields. This is Treasury-led monetisation that may temporarily suppress volatility but risks faster money-supply growth and higher inflation
- **China is the main liquidity exception**, with PBoC reflation moving counter to the US and Eurozone cycle. Chinese liquidity is supporting gold, domestic reflation, and potentially Chinese assets
- **Asset allocation should become more defensive**, with reduced credit exposure, caution on long-dated bonds, continued commodity exposure, and preference for monetary inflation hedges such as gold. There is a strong case for materially higher oil prices as the gold/oil ratio mean-reverts and global business activity broadens

Global Liquidity Is Turning Lower

We are deep into a regular five-to-six-year Global Liquidity cycle. In this phase, liquidity pushes asset prices higher; rising collateral values then stimulate more lending and greater leverage. As the cycle matures, the quality of both lending and collateral deteriorates faster than the volume of liquidity expands. This spells trouble.

Early in the cycle, central banks often encourage this momentum. Later, they are constrained by their inability to control it: markets have become too large. Policymakers therefore tend to move too late, before being forced to brake hard and manage the damage.

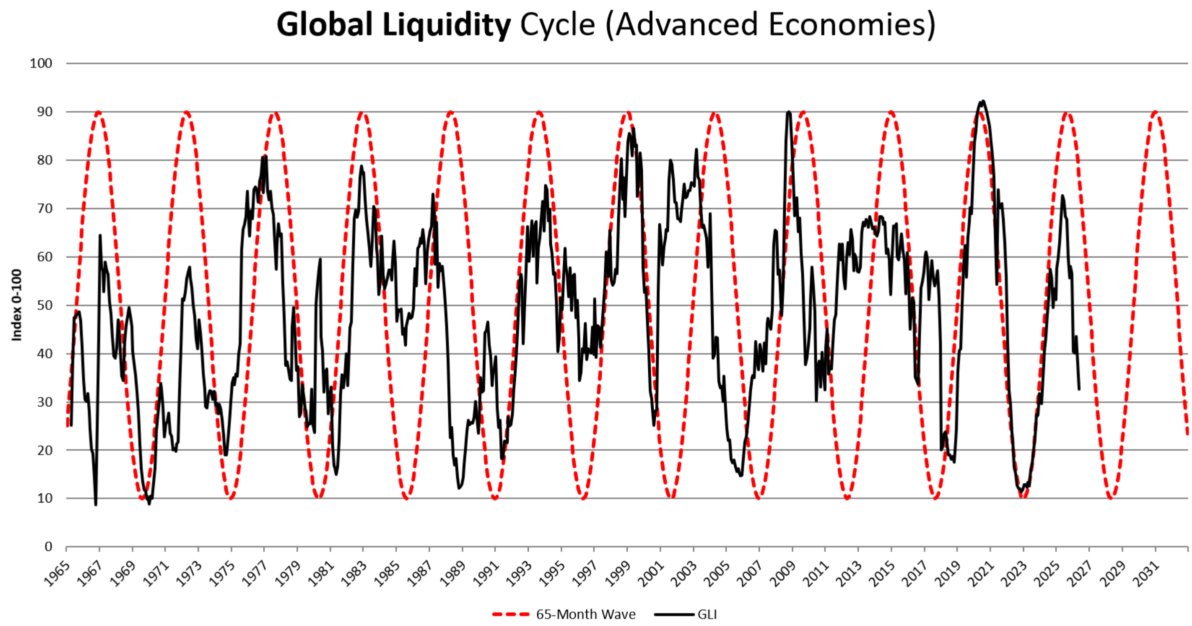
Cycle Positioning and Regional Divergence

Global Liquidity has already peaked and is now turning lower. That shift raises the prospect of higher volatility and a more defensive investment regime, although China remains the main exception. The pace of decline eased slightly in July, largely because of renewed easing by the **People's Bank of China** (PBoC) and, to a lesser extent, a modest rebound in US Fed liquidity. Even so, the Global Liquidity cycle continued to weaken and is unlikely to bottom before late 2027.

- The Global Liquidity Index (GLI™) fell to 36.0 at end-July 2026, against a normal range of 0–100
- Advanced economies dropped to 32.6, confirming weakness in the core markets
- World Central Bank Liquidity improved to 45.0, partly cushioning the decline

Figure 1 highlights the Global Liquidity Index for the advanced economies, reported from the mid-1960s and overlaid with a 65-month repeating sine wave. The index measures the underlying momentum of liquidity, rather than its absolute level. The message is clear: financial-market liquidity is slowing rapidly.

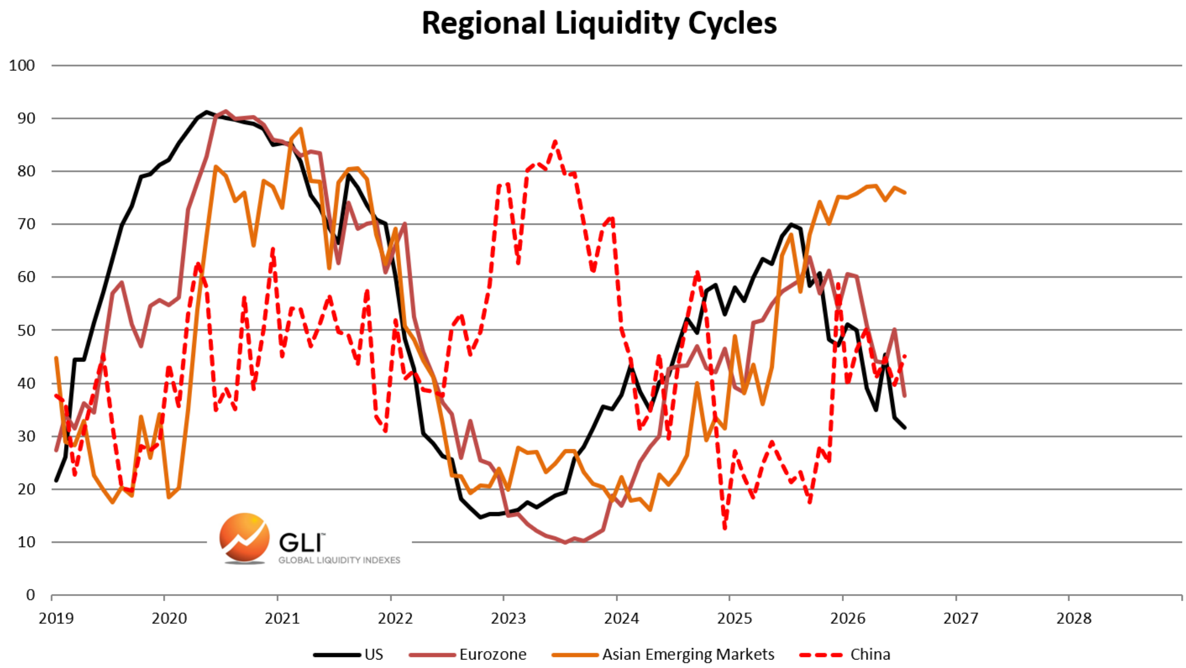
Figure 1



Digging deeper, the July data show US Liquidity slid again to an index of 31.6 and liquidity conditions are now tighter than Japan at 38.5. Eurozone Liquidity is closely following the US cycle. It fell to 37.6 at end-July. China picked up slightly to 45.1, helped by PBoC support (index 55.1). In contrast, Emerging Asian Liquidity remained high an an index of 75.9 and UK Liquidity jumped again to a sky-high 80.5.

The broad regional picture is reported in Figure 2. This confirms: (1) the close **co-movement of US and Eurozone Liquidity**; (2) the associated, but lagging and more **exaggerated Emerging Asian cycle**, and (3) the **anti-cyclical movements of Chinese Liquidity**.

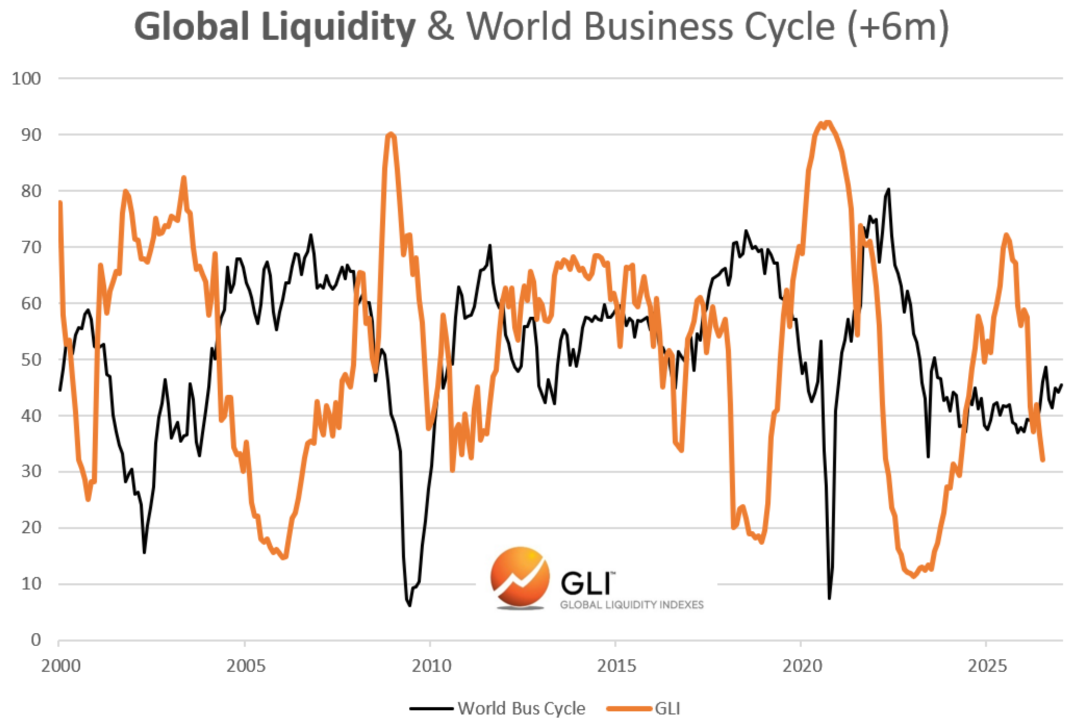
Figure 2



The reason behind the peak and subsequent weakness in Global Liquidity came initially from a sharp fall-off in private sector liquidity. Figure 3 shows that *'…all money that is anywhere must be somewhere'*. In other words if liquidity is driving higher financial asset prices, then it is not available for real economy use. Similarly, vice versa.

This is a typical late-cycle sign and corresponds to an acceleration in economic activity, which starts to pull liquidity from the financial sector towards industry. As business activity gains traction and inflation pressures rise, then Central Banks begin to tighten more aggressively.

Figure 3

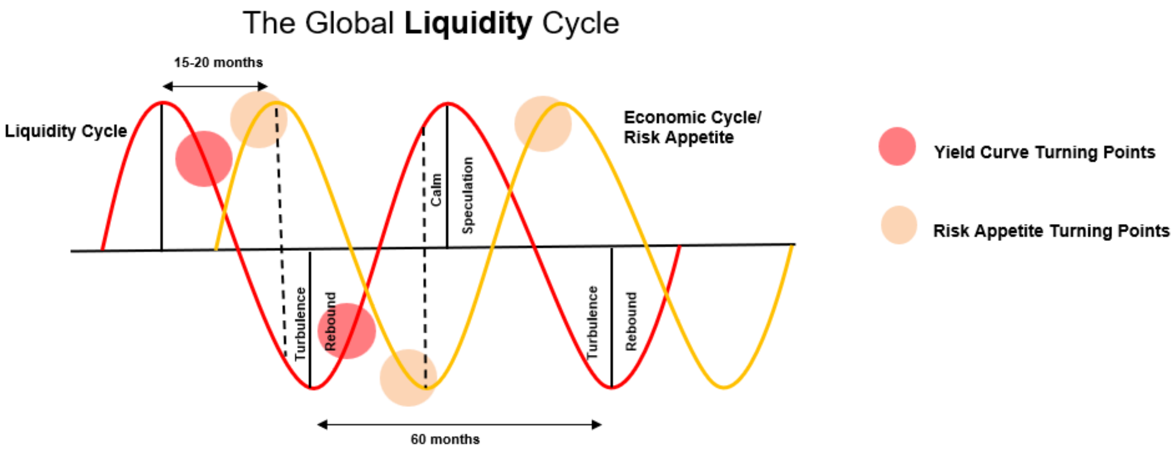


Strong economic activity is more obvious in some areas than others. Evidence the rebound in the US ISM manufacturing index and the persistent gains in commodity markets, such as copper, shown in Figure 4. Commodities typically perform strongly around the peak and early falls in the liquidity cycle.

Figure 4

This sequencing between the financial and real economies shapes our asset allocation views. Figure 5 is a schematic diagram that shows the notional lead-times and the four phases – *Rebound, Calm, Speculation and Turbulence* – of the investment cycle. Based on the GLI data, we are currently positioned between the liquidity cycle and business cycle peaks. Already, we have seen yield curves fall through 2026, but we have yet to see any serious reversal in investor sentiment: this typically comes a few months before the business cycle peak.

Figure 5



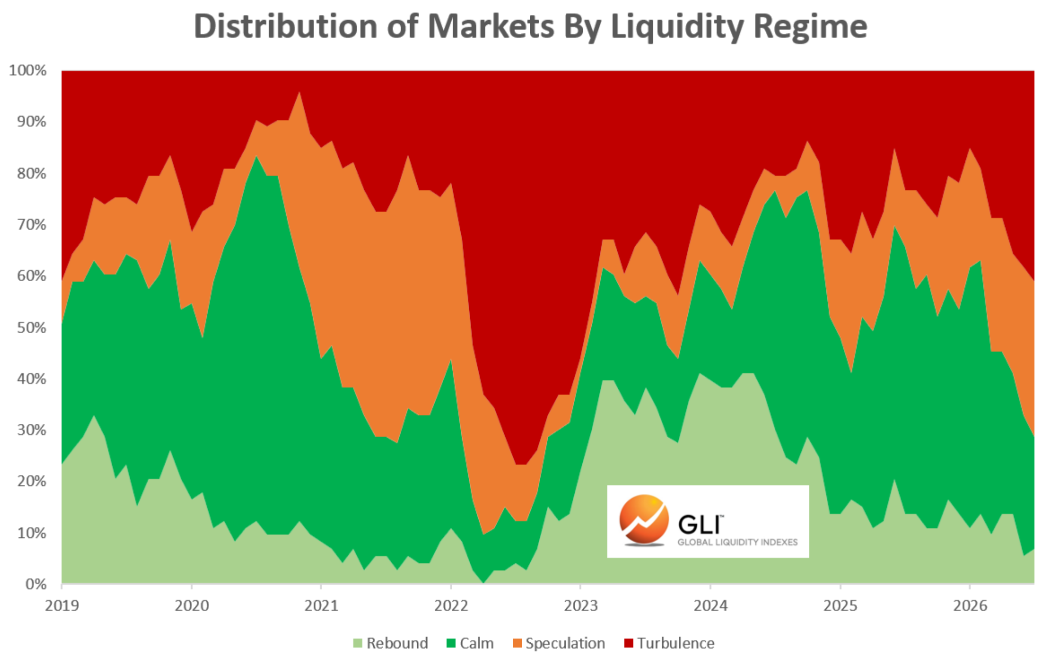
Our investment views for this year, based on the Global Liquidity cycle, remain in place:

- **Global Liquidity** has peaked, signalling a 'Speculation' investment regime
- Peak Liquidity is mainly the result of a **strengthening World economy** (and notably US economy) which are crowding out financial uses
- **China's Liquidity cycle is moving oppositely** to the Advanced economies

Several investment conclusions follow. Asset markets may still generate positive returns, but return quality is likely to deteriorate as volatility rises. Asset allocation should therefore become more defensive: reduce credit exposure, avoid longer-dated bonds, maintain commodity exposure, and add monetary inflation hedges on weakness.

Figure 6 shows the evolution of the global investment cycle, highlighting the distribution of each of the four investment regimes. The weighted aggregate suggests that investors still face a Speculation phase, but the simple count of markets (unweighted) suggest that there are increasingly more entering the Turbulence phase.

Figure 6

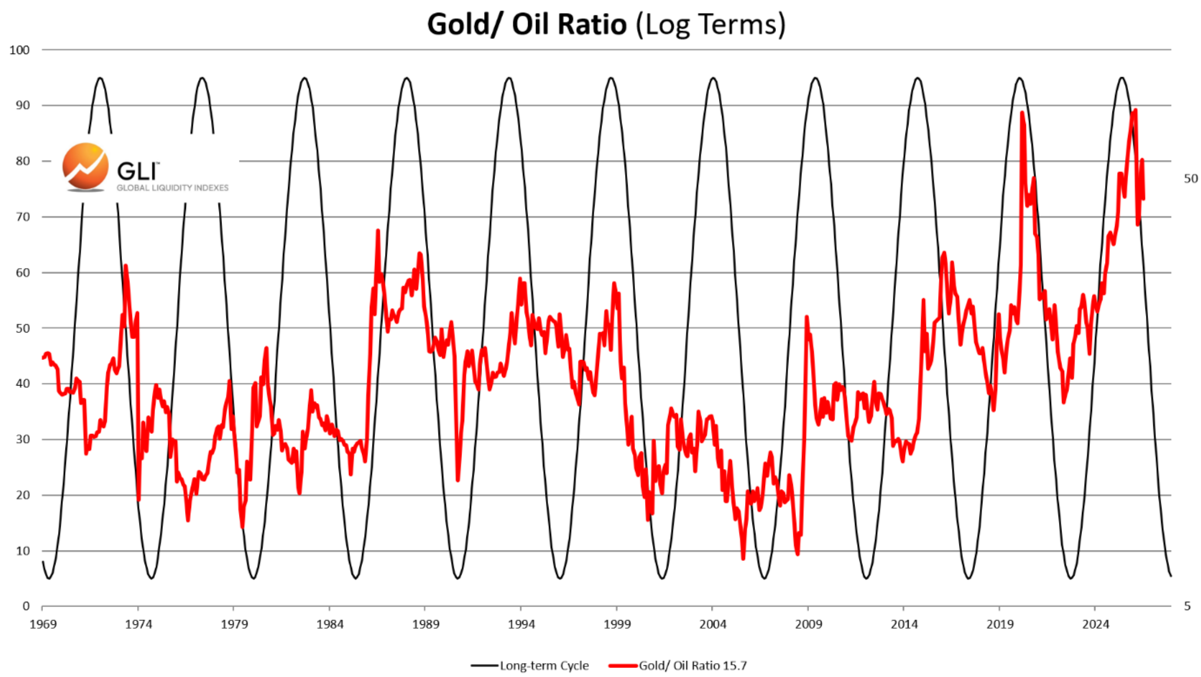


The Compelling Case For Higher Oil Prices

Looking ahead we not only see further gains in commodity markets, but we expect oil prices to pick-up sharply, based more on economics than geo-politics. This projection of higher oil prices relies on two moving parts: (1) the technical **gold/ oil** ratio, which is dominated by relative extraction costs, and (2) the nominal **US dollar gold price**. Assume for now that gold remains around US$4000/ oz. The gold/ oil ratio is expressed in log terms (right scale) and plotted relative to the underlying 65-month Global Liquidity cycle in Figure 7. This shows how it typically rises with expanding Global Liquidity and falls consistently alongside. This likely occurs because rising business activity saps financial liquidity and simultaneously boosts industrial commodity prices.

The gold/ oil ratio has averaged around 20 times since 1970. The data reveal a modest upward trend, but this is unable to justify the latest high reading of 45 times. The data highlight strong mean-reversion back to 20 times over a 3-4 year period, including the similar COVID spike. This points to a US$200/bbl oil price, or, using a more conservative 30 times ratio, a price around US$135/ bbl.

Figure 7



Higher oil prices have frequently called a halt on strong financial market performance. This is another reason why portfolio beta should be trimmed. As World economic recovery broadens out, most international markets are likely to follow the Global Liquidity cycle lower. However, China may be the exception. **While acknowledging the late stage of the World investment cycle, portfolios should consider relatively greater exposure to China.**

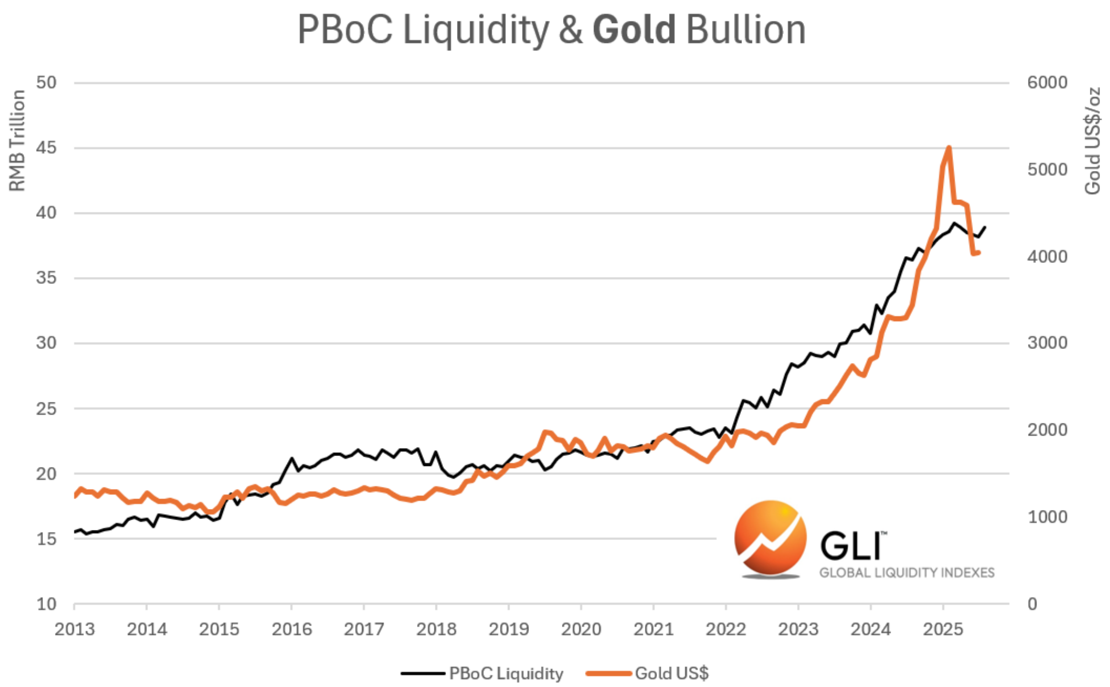
Oil, Gold And China

Chinese monetary policy has lately flip-flopped. After several months of expansion, the size of the PBoC balance sheet dipped sharply from early March through mid-June. We argued last month that this was likely a response to heightened Iran tensions and the threat to Chinese oil imports. A slower Chinese economy would help cap any spike in World oil prices.

Looking ahead, China has to **debase the value of the Yuan domestically** in order to tackle her huge internal and embedded debt problems. Evidence the widening gap between rising World bond yields and collapsing Chinese yields. This attests to debt-deflation. By expanding domestic liquidity, the PBoC is 'printing money' and hence trying to devalue the domestic Yuan by raising the level of wages and prices relative to the nominal value of outstanding debts.

Chinese Liquidity mainly travels through two conduits: a rising gold price in RMB and stronger domestic, and therefore regional, economic activity. Figure 8 shows the close correlation between the size of the PBoC balance sheet and gold.

Figure 8



Rigid capital controls, a large nest-egg of foreign reserves and compliant State banks **prevent this liquidity from affecting the external value of the Yuan**, e.g. the US$/Yuan cross. Chinese retail investors can protect their wealth against this monetary debasement by investing in gold and silver, but they are forbidden from investing in cryptocurrencies: an illegal area where China has recently doubled-down on restrictions. Continued expansion in Chinese Liquidity is therefore likely to support further advances in bullion prices. Not surprisingly, China's *Shanghai Gold Exchange* has become the marginal price setter, eclipsing London and COMEX.

Figure 9 shows recent daily movements in the size of the PBoC balance sheet. The PBoC cut liquidity injections from early March, coincident with the Iran Crisis and restarted them around the time of the fragile MOU. This liquidity dip, which hit the gold price, may have been deliberately designed to cool the economy and slow oil demand, so helping to contain the oil price spike. Whatever the reasons, the PBoC appears to have restarted injections and their rising trend is supporting the increase in gold prices.

Figure 9

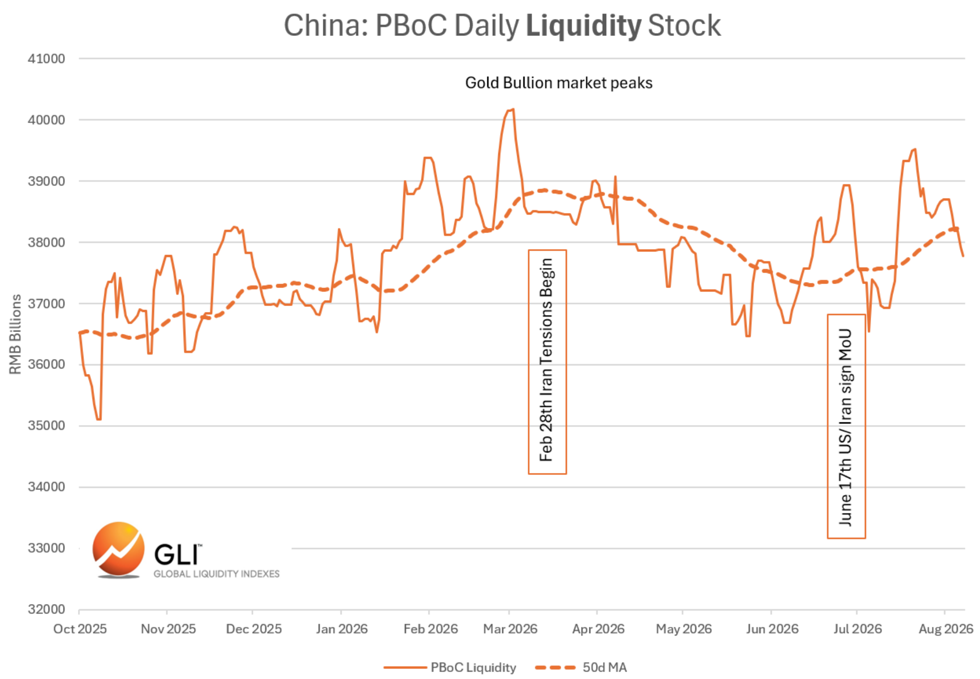
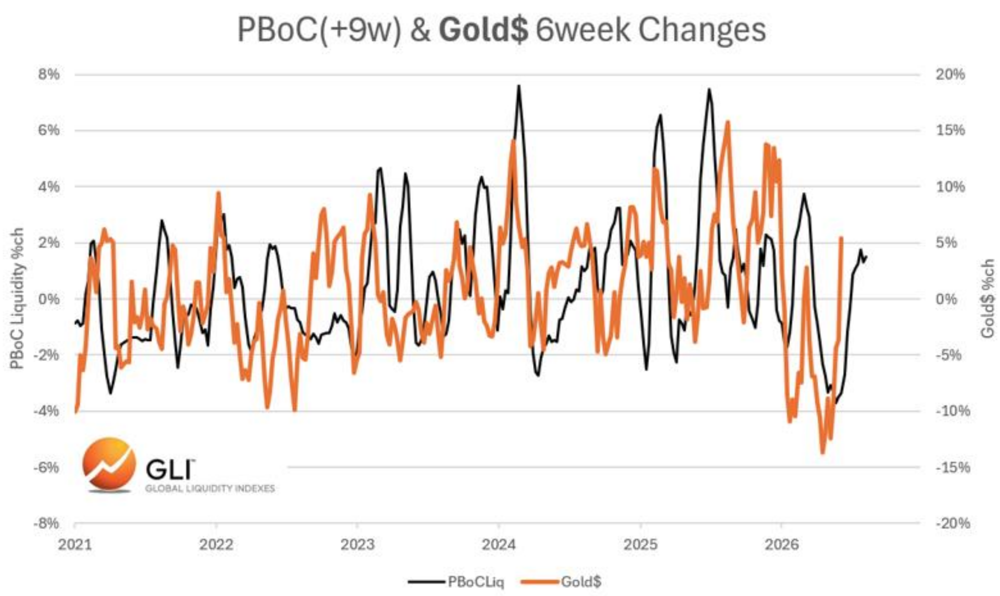


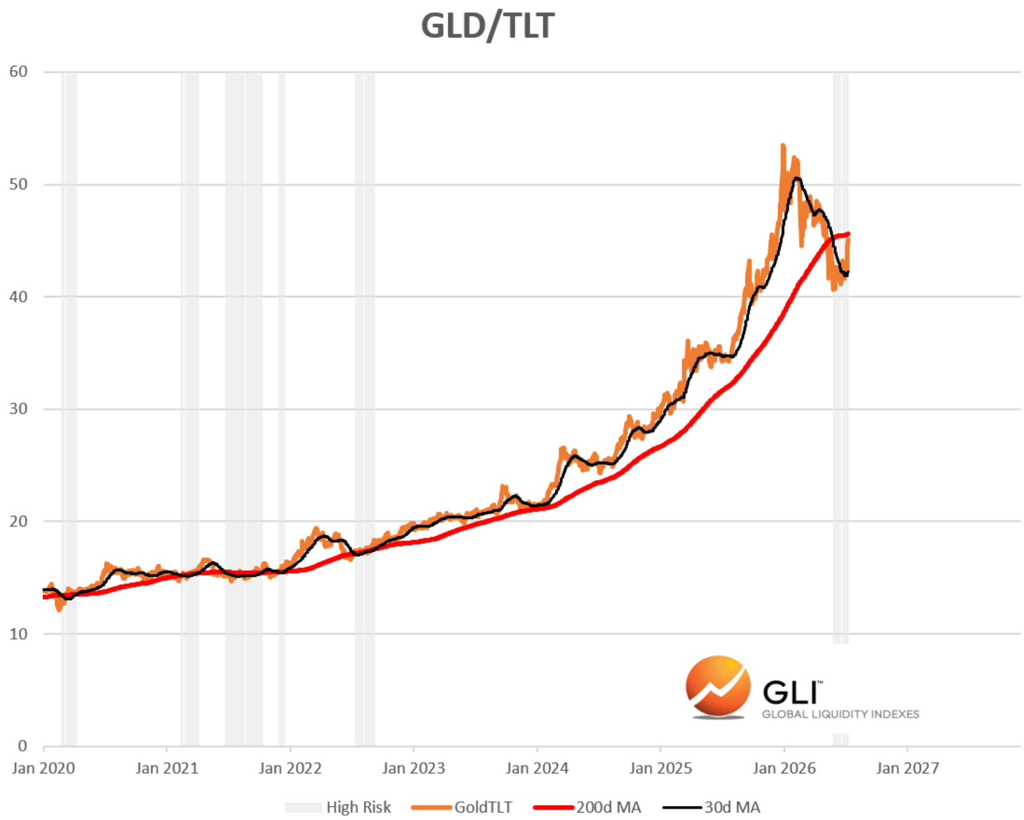
Figure 10 evidences the close co-movement between the PBoC balance sheet and bullion prices. We track 6-week log changes to eliminate noise, and the change in the PBoC balance sheet appears to lead by 9 weeks. Hence, it is mostly China, not the West driving gold prices. Rising US bond yields have not mattered (falling Chinese yields may help), and the key factor is greater PBoC liquidity.

Figure 10



Gold should outperform other monetary inflation hedges such as Bitcoin, which is more sensitive to Global and US Fed Liquidity. The popular long gold-short US Treasuries trade, represented by GLD/TLT, should also revive. More Chinese Liquidity is likely to support GLD, while governments under populist pressure remain reluctant to rein in primary spending. That combination fuels both higher debt and faster NGDP growth, leaving TLT vulnerable. See Figure 11.

Figure 11



Ominous Fiscal Strains

More active government and more directed public spending, the "Big State," are also inevitable facets of what we generically term "Capital Wars." The US has focused its efforts on containing China through tariffs, technology controls, more robust supply chains, secure critical-mineral supplies, strategic investment stakes, and higher defence procurement. The funding bill grows, but business activity also receives a short-term uplift.

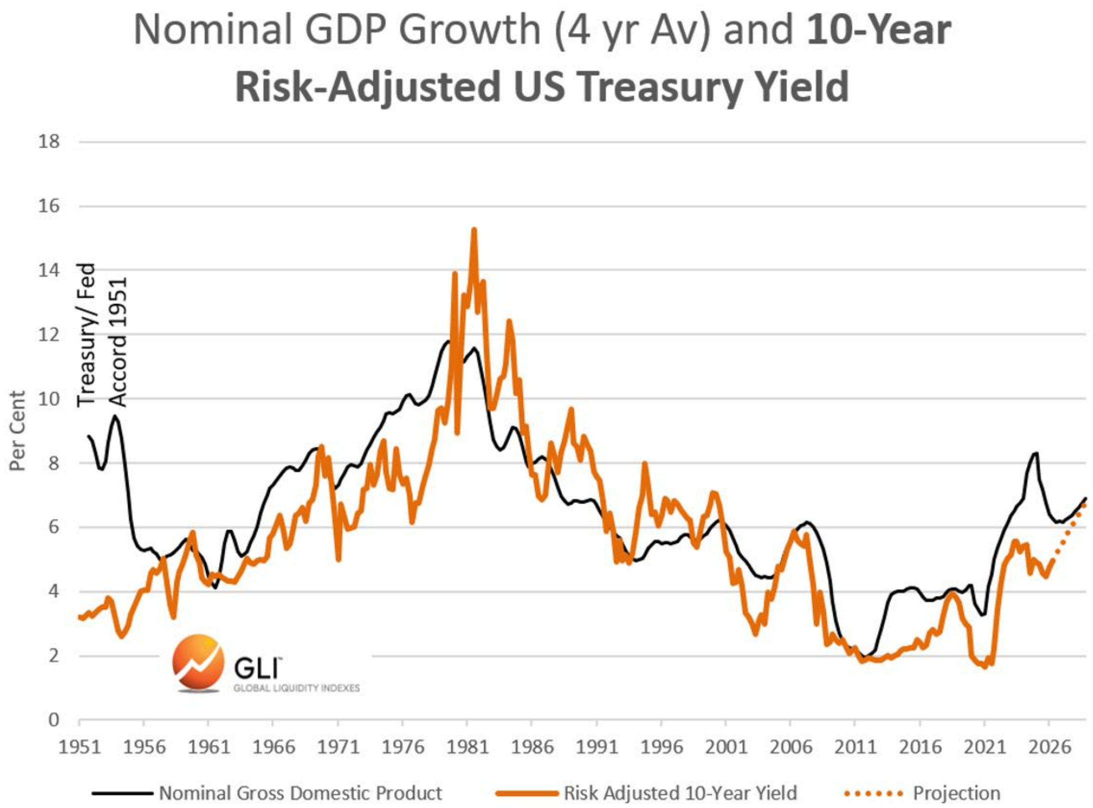
Many economies have responded to recent higher oil prices with subsidies rather than conservation. On top, Germany is preparing to loosen its debt brake for infrastructure and defence, while Japan is considering a similar shift alongside additional tax cuts. France has long allowed its fiscal deficit to spiral higher, and even Britain is openly discussing greater fiscal flexibility.

The plain fact is that fiscal pressures are building worldwide. The persistently weak Yen implicitly signals that Japan is running out of fiscal space. Bank of Japan buying of JGBs may help cap long-dated yields and prevent a debt crisis, but it also stops bond markets correctly pricing risk. Hence, capital exits and the Yen devalues. Britain suffered similar strains during the ill-fated Liz Truss premiership.

Ironically, more than 15 years ago in the wake of the GFC, the G20 committed itself to fiscal consolidation. Those commitments proved empty. Gross public debt to GDP is now some 15 percentage points higher and still rising. Low interest rates encouraged many governments to keep spending, while structural forces such as ageing populations and shocks such as the Ukraine invasion, Iran tensions, and the China threat added further demands.

These funding demands inevitably add to bond term premia. In addition, strong NGDP growth resulting from loose fiscal policies pushes up underlying risk-adjusted bond yields, as Figure 12 confirms. Adding these yield components together plainly points to higher actual long-term yields. Based on a underlying 6-8% NGDP trend, US 10-year yields deserve to easily test 6%.

Figure 12



Like the BoJ, both the Fed and the US Treasury are trying to contain rising yields. US policymakers are using three tools: (1) **shifting funding away from the long end and toward bills**; (2) **limiting bond volatility** to encourage leveraged investors to absorb scarcer long-dated issuance; and (3) relieving any resulting pressure at the short end by **adding liquidity to money markets**.

At the last Fed press conference, Chair Warsh explicitly emphasised the "ample reserves" regime — in effect, liquid money markets. The recent QRA followed the same pattern: more bill financing and greater Treasury buybacks to cap yield volatility. This should be understood as a subtle shift in QE policy: it is now directed by the Treasury

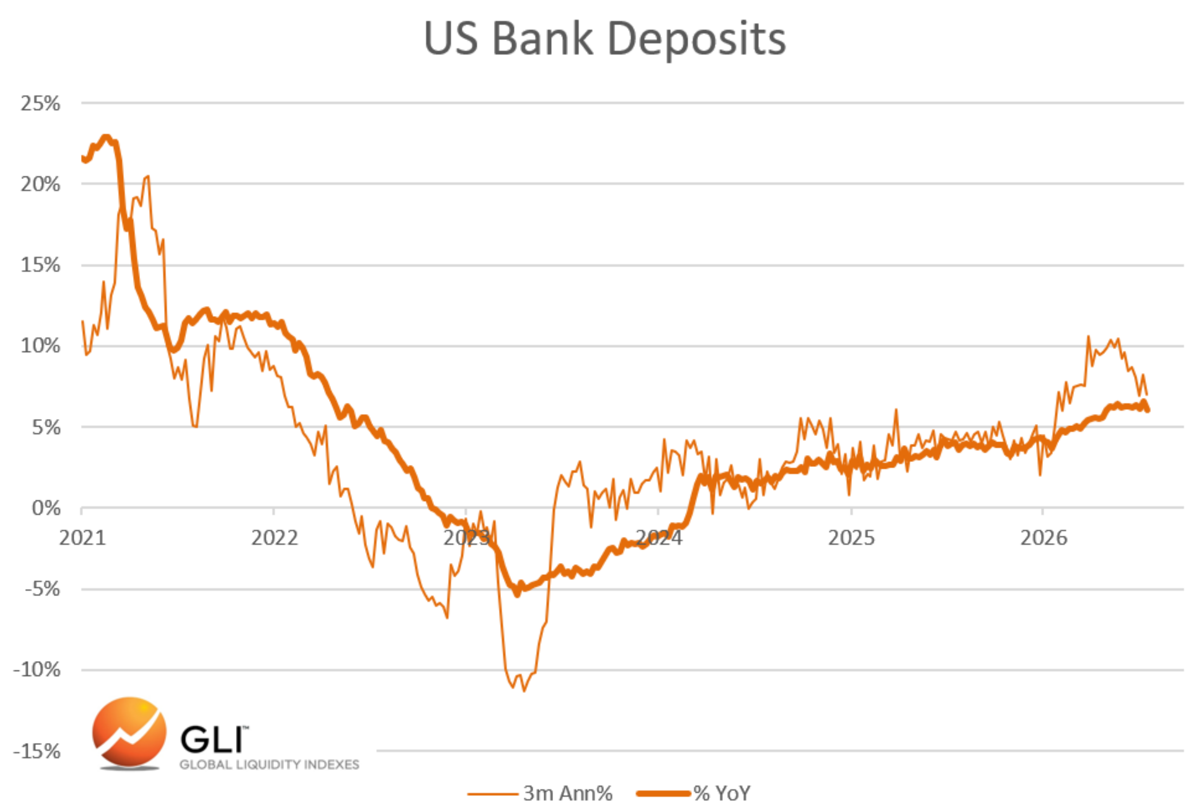
(“Treasury QE”) and funded by the private sector, particularly banks, rather than directed and funded by the Fed, as in earlier rounds of “Fed QE”.

Other major economies are copying this financing model, as shown by the shortening average tenor of their gross issuance. Funding at the short end is comparatively straightforward because, when fiscal policy is loose, banks have a strong appetite for short-dated government paper that better matches the duration of their liabilities. Yet make no mistake: **this is monetisation**. History suggests it ends badly.

Policy Must Tighten

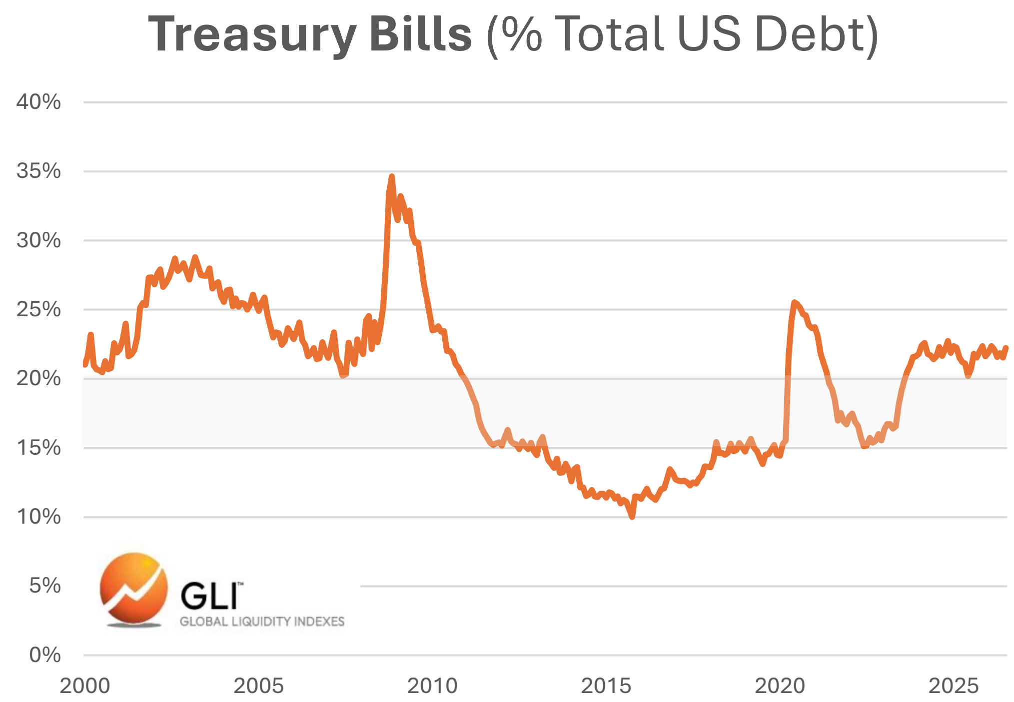
Yield-curve control is difficult and costly, as Japan and Australia have recently shown. Markets have become too large, and policymakers are likely to be exposed by evidence of **accelerating money supply growth**. The mechanism is straightforward: large fiscal deficits boost bank deposits, and banks then buy Treasury bills and short-dated coupons to duration-match their expanded balance sheets. Everyone appears comfortable, but M2 expands. Figure 13 shows that US bank deposits, the dominant component of M2 money supply, recently rose at an annualised pace of more than 10% over three months.

Figure 13



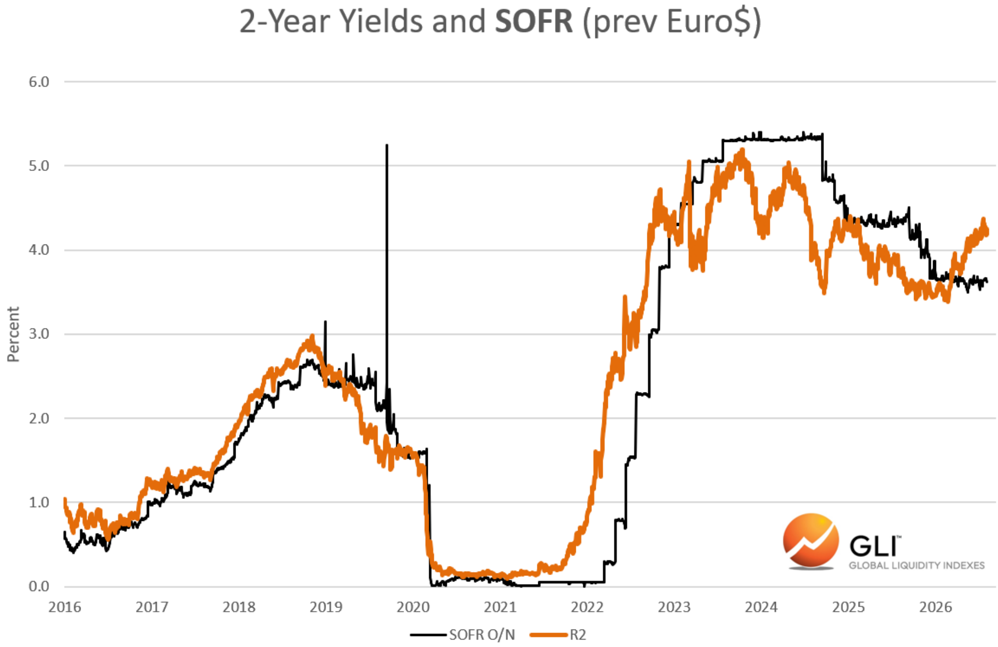
This tension appears in a forcibly steepening yield curve. This is the real test of the Policy Makers Vs the Markets. Because long-term yields typically drive short-term yields, strong NGDP growth should pull the entire yield structure higher; as yields rise, the curve naturally tends to invert. To prevent that outcome, the Treasury must either double down by further raising bill issuance, or the US Fed must inject ever more short-term liquidity into money markets to keep repo rates contained. Figure 14 shows that bills made up a far higher percentage of Treasury debt in the early 2000s. Lately, bills comprise around 22% of outstanding debt. This is above the previously signalled 15-20% threshold, but it is not inconceivable that a desperate Treasury could evens push this back towards 30%.

Figure 14



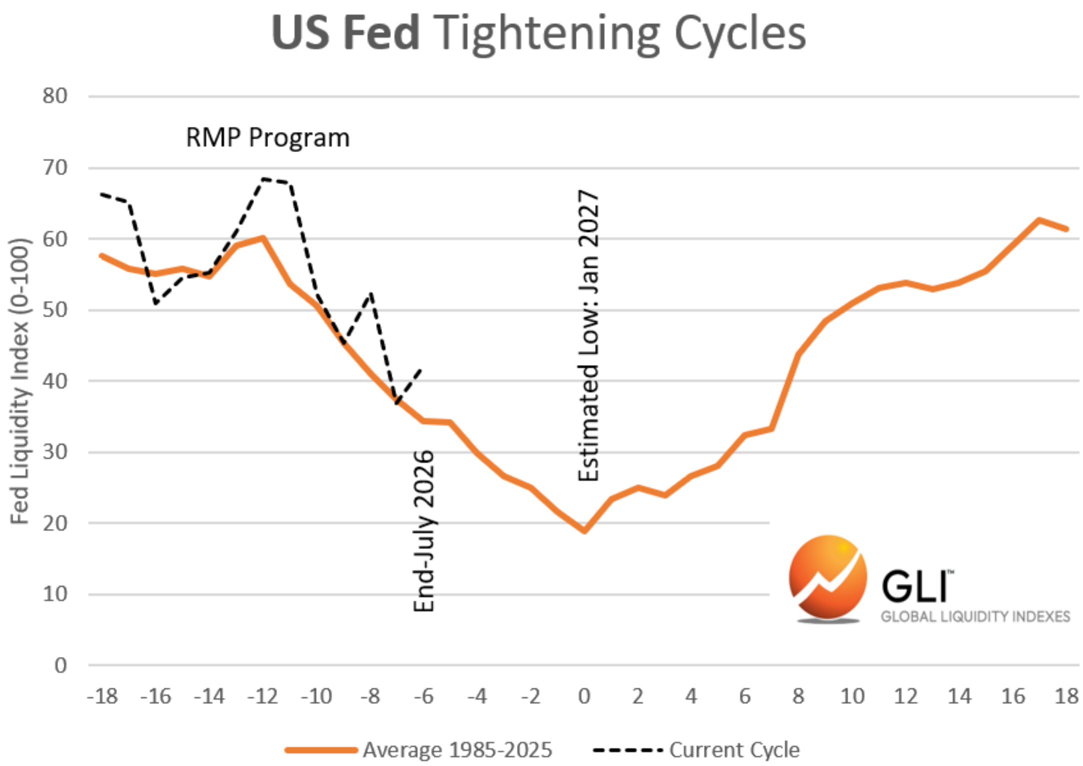
These policies are like holding an inflated beach ball underwater: temporary, unstable, and liable to end with a sudden release. The more repo liquidity the Fed supplies, the more bank balance sheets and money supply expand — raising the risk that NGDP and main-street inflation accelerate. That, in turn, should add further upward pressure to bond yields. Already, US 2-year Treasury notes are pricing higher policy rates. An AI cross-check suggests that this signal has been correct about 85% of the time. See Figure 15. Recall that the long end of the rates market (orange line) drives the short end (black line), not vice versa.

Figure 15



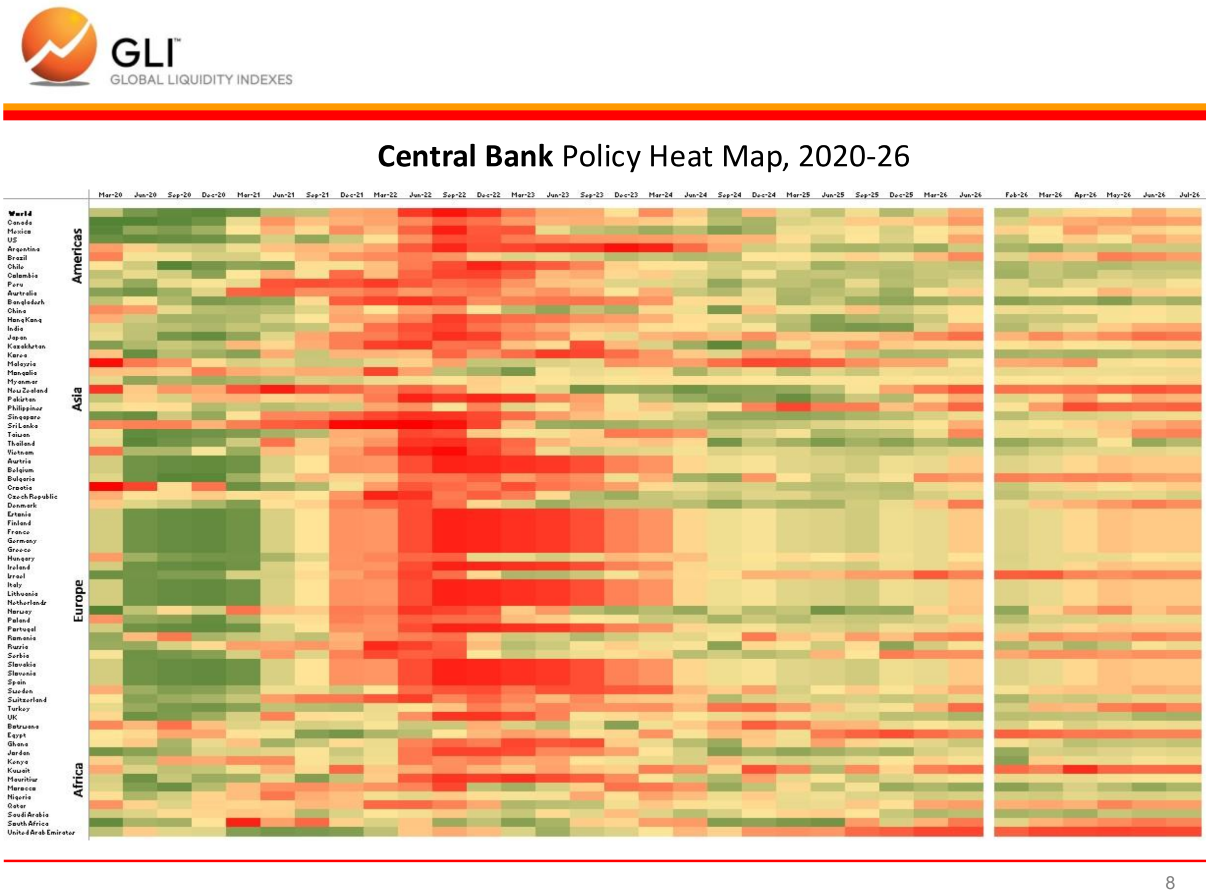
Although Chair Warsh has been sending mixed signals, this suggests that the Fed must itself undertake or encouage the markets to tighten further. Thus far, the Fed has been surrepticious. Our broad measures of Fed activity show policy progressively tightening. We estimate that US banks' reserves have dipped and are now barely in-line with necessary levels, while the recently introduced RMP (Reserve Management Purchases) has fallen back to around 40% of its peak levels. In fact, Figure 16 confirms that US Fed policy is closely tracking the average 1985–2025 tightening pattern. Extrapolating the data implies that the Fed may need to intensify the liquidity squeeze for roughly another six months.

Figure 16



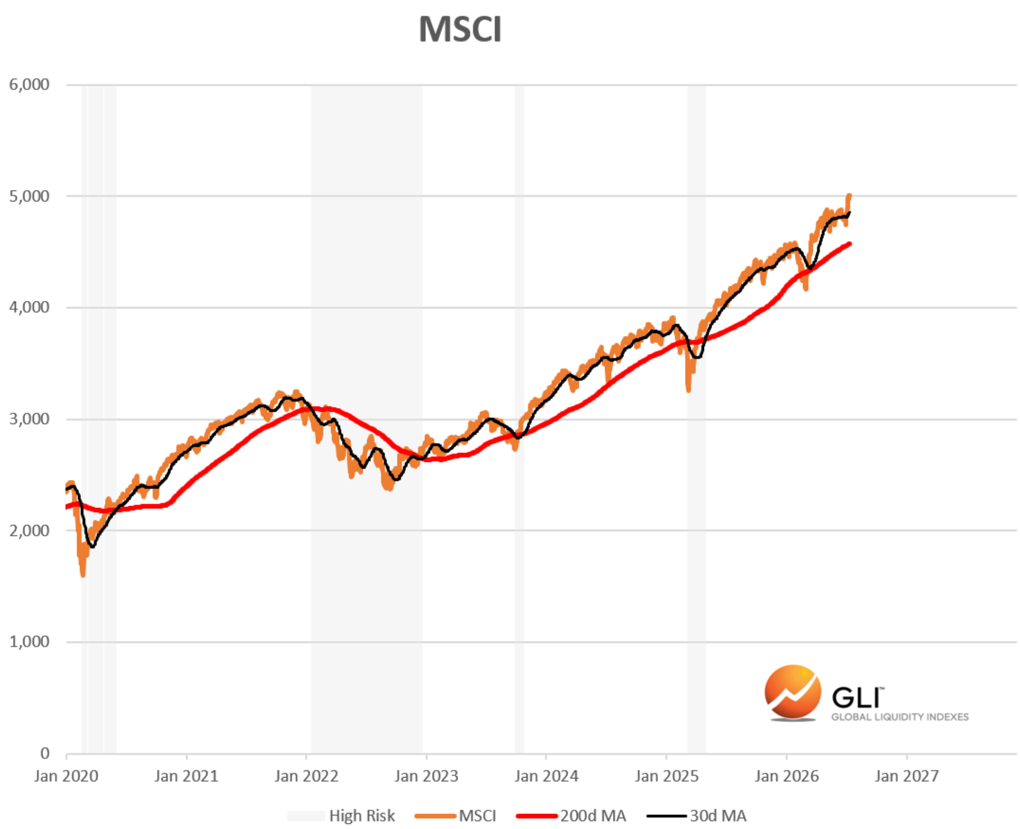
What's true of the Fed is likely true elsewhere. Indeed, a consequence of Fed tightening will be a stronger US dollar, given the scale of leverage Worldwide. This should broaden the coming squeeze. [Sidenote: any respite resulting from say a larger shift towards bills and consequent faster money growth, would instead weaken the US dollar.] The heatmap in Figure 17 confirms from the changing hues that World Central Bank liquidity is progressively tightening. The left hand block of tiles are quarterly readings and the right hand block report the latest six months. Compared to the last tightening cycle, this positions investors in the equivalent of Q4, 2021.

Figure 17



For reference Figure 18 shows how the MSCI World stockmarket index performed over that period. Spoiler alert: it wasn't great.

Figure 18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GLI
GLOBAL LIQUIDITY INDEXES
High Risk
MSCI
200d MA
30d MA