MACROLENS
Markets in High Resolution

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The Liquidity Landscape

Global liquidity conditions are the paramount variable in a "risk-on / risk-off" world. Let's set the stage for the coming barrage of "2020 outlook" pieces with a review of the liquidity landscape.

An abundance of Dollar debt across the EM world renders local debt serviceability subject to liquidity conditions in the Dollar realm. Less appreciated is the fact that **China's quasi-fixed exchange rate exposes its $40T+ in local RMB credit** subject to the same volatile forces.

With the vagaries of Dollar liquidity conditions transmitted to China's enormous credit bubble via the "pegged" USDCNY rate, **China serves as a great amplifier of fluctuations in the U.S. monetary stance**.

(My recent interview for Real Vision lays out the 'impossible trinity' framework which dictates that **Dollar liquidity conditions are a critical determinant of the degree of "stimulus"** in China).

The **relationship between Dollar liquidity and prospects in China is reflexive**. In normal conditions the process is self-reinforcing: tightening Dollar liquidity slows Chinese growth (and/or hits the RMB), triggering "risk-off" conditions that further weigh on Dollar-liquidity creation (via perceptions of counterparty risk, willingness to provide leverage, etc.).

But as we learned after Janet Yellen's visit to Shanghai in February 2016, **China is too big to fail**.

Dollar liquidity conditions drive China until China approaches a tail, at which point **causality can flip** as market feedback solicits a counteracting response from the Fed (or not, in which case – kaboom). China's Dollar-pegged credit bubble is a big reason **why the Fed keeps bumping up against limits** to its tightening efforts.

This is why the 'trade war' has necessitated a reversal of the Fed tightening. It's not the 'tariff uncertainty' (The Uncertainty Narrative, 10/23/19). It's the **deleterious effect on global liquidity conditions of the specter of a tail event** in China and/or Hong Kong.

With that backdrop, let's take a look at some of my favorite liquidity indicators. The Fed appears **in the general vicinity of a neutral stance.** But the situation remains tenuous.

The Fed better be on its toes if a Phase One breakdown raises the specter of a China tail.

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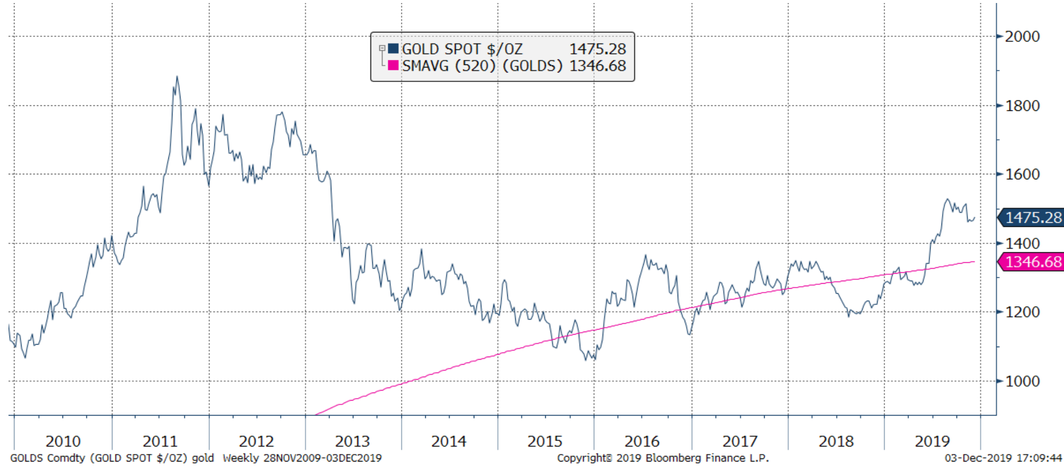
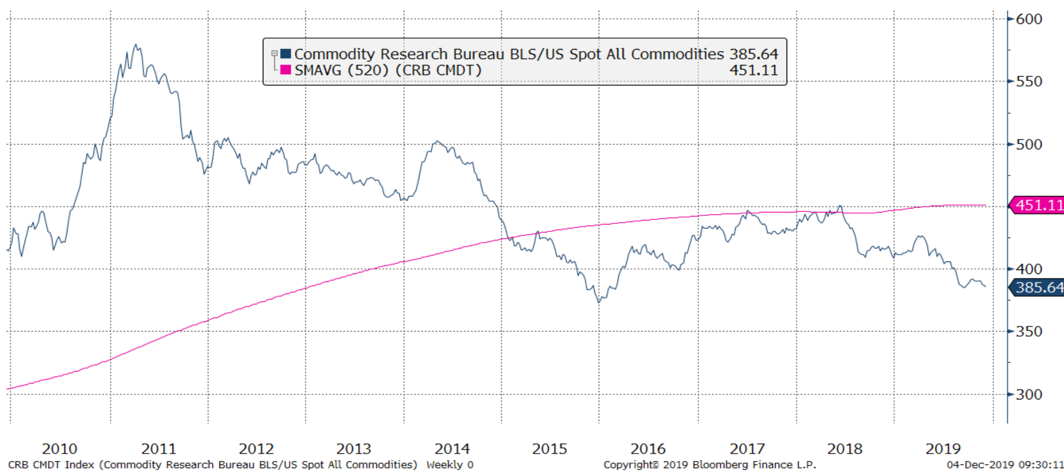
Gold: Moderately Risk-Positive

- My "desert island" liquidity indicator
- ~10% above the 10-year MA, gold prices reside on the **risk-friendly side of equilibrium**
- Unfortunately, my "desert island" indicator is itself on an island: **it's an outlier**.



Commodities: Risk-Negative

- Commodities have diverged dramatically from gold this year, retracing to cycle lows
- The commodity bear-market is a big driver EM / DM relative equity performance



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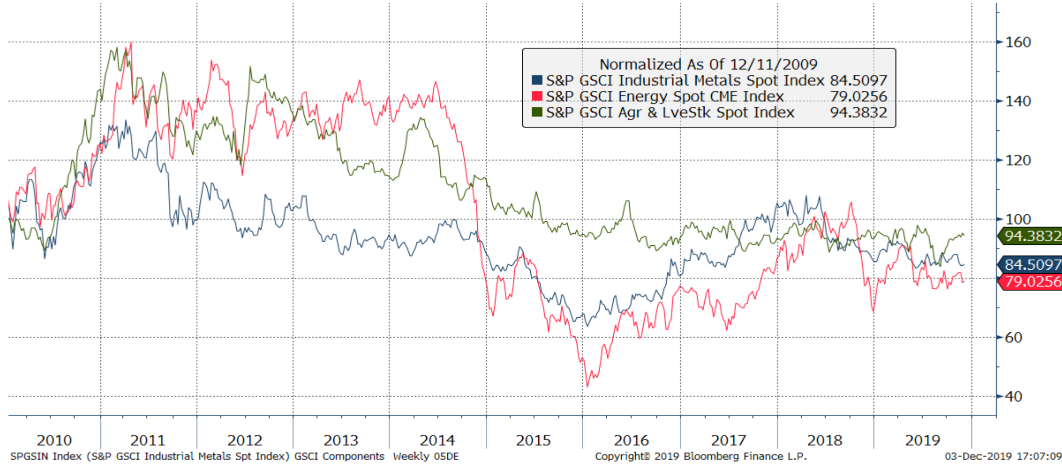
Commodity Sub-sectors: Don't Blame China

- Energy, Metals, and Ags are **all down** on a decade ago
- If China was causal to commodity price weakness, metals would underperform
- Weak commodity prices are largely attributable to 'snug' monetary conditions



The Dollar Index: Risk-Negative

- **A sustained acceleration in inflation is impossible** with a strong currency

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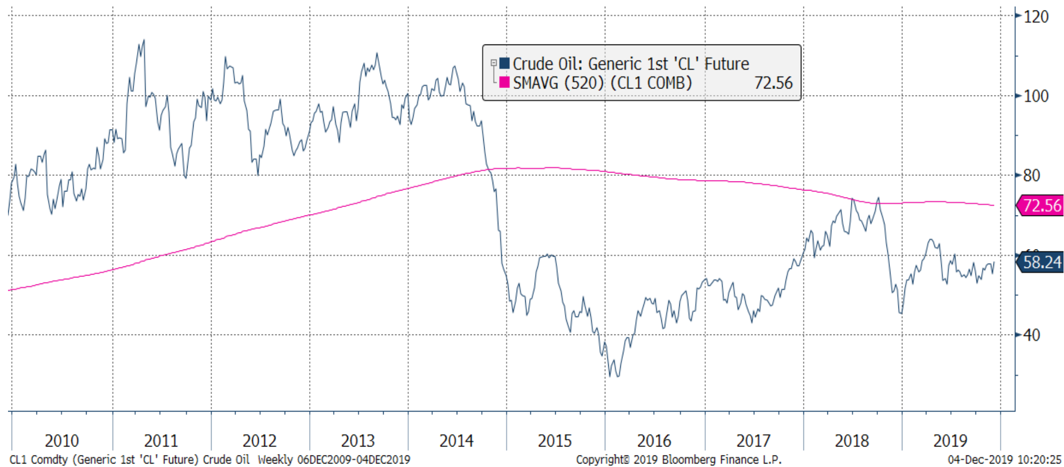
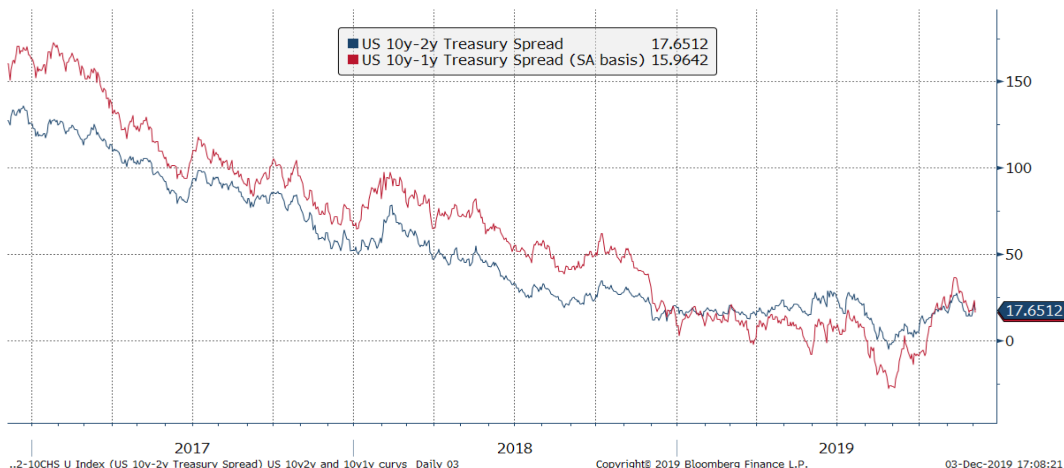
Crude Oil: Risk-Negative

- The chart of Crude Oil, aka "black gold," looks like DXY upside down
- A sharp break in 2014-15 sent crude to a new, less-inflationary, range



The Yield Curve: Flashing Yellow

- The Yield curve is out of the woods for now but **could easily re-invert** in the case of a "Phase One" breakdown



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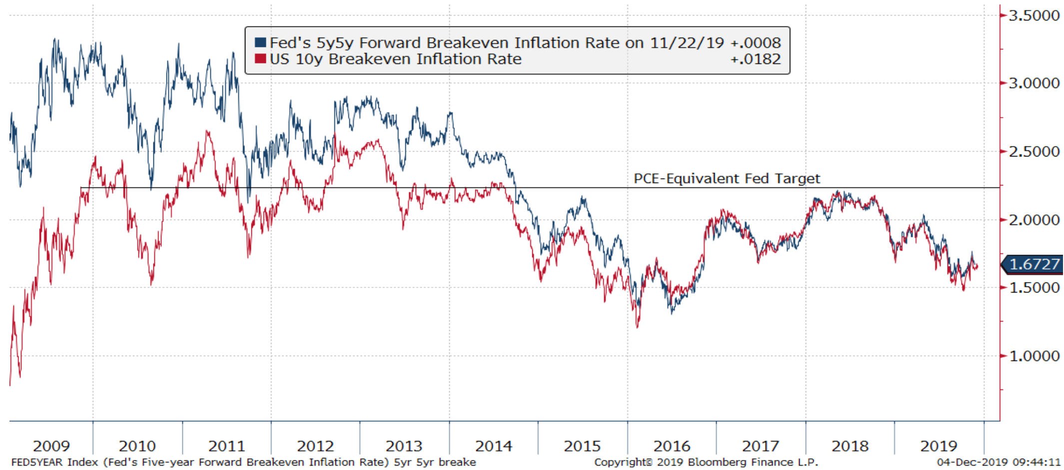
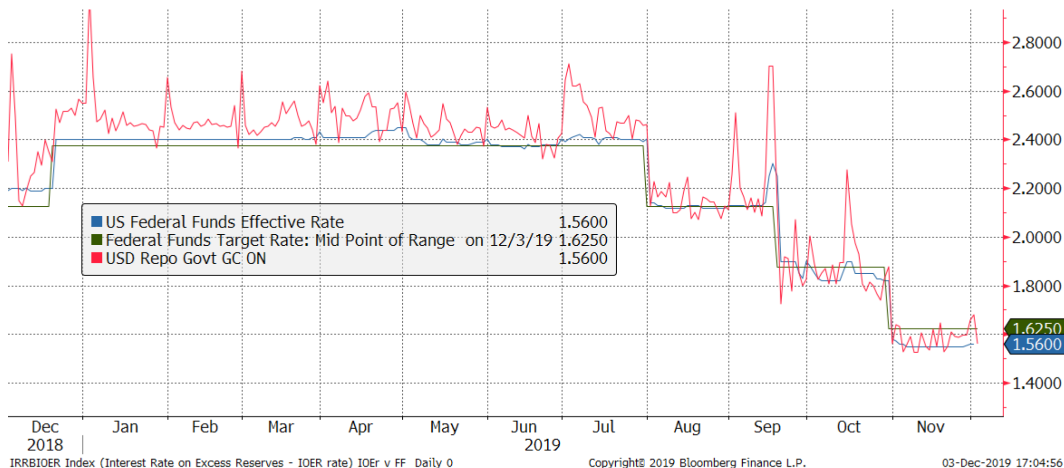
Breakeven Inflation Rates: Unambiguous Fail

- An unambiguous market verdict: **The Fed is too tight to achieve its stated objective**
- The Fed's musings on "target symmetry" are farcical in light of this chart



Short-term Funding Markets: Much Ado About Nothing

- The Fed had **a technical problem with its operating mechanism** due to an insufficient understanding of new liquidity regulations
- That problem has been fixed: **Repo rates are down by nearly 100bps**.



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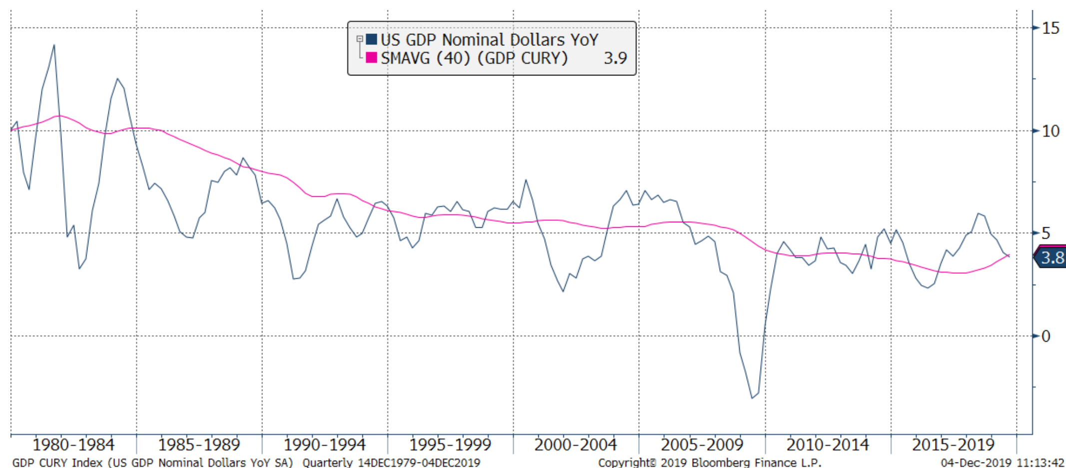
Conclusions

- Gold is an outlier – perhaps acting **more as a barometer of tail risk** than liquidity conditions
- Ex-gold, the message is consistent: **The Fed continues to flirt with "too tight" policy**
- **Something happened in 2014-15** which generated a significant tightening in global liquidity:
    - The Fed's **exit from QE was premature.** QE works through a "credible commitment to irresponsibility: for markets to take the liquidity and lever up with it, **participants must believe that the central bank will allow the resulting inflation** to happen.
    - By touting QE exit in 2014 while still undershooting the inflation target, **the Fed's "credible commitment" proved to be "time-inconsistent."** While balance sheet reduction was still many months away, **the QE effect was largely unwound in 2014-15**.
    - Markets have been dealing with the fallout ever since, as **liquidity continually bump up against the danger zone**, necessitating a string of Fed responses that look like "Fed puts."
- Nominal GDP growth determines debt-serviceability. Just as we *finally* peeked at pre-crisis nGDP growth levels, the Fed slammed the brakes. **The debt load remains nominally "heavy."**



- The Fed has corrected what could have been a damaging deflationary error, but **policy is not yet in an "accommodative" stance.** **Markets remain vulnerable to a self-reinforcing volatility episode if the Fed fails to respond to a Phase One breakdown**.
- **I like long February Fed Funds futures as a low-cost play on a Phase One breakdown.**

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