The Liquidity Landscape and Risk Asset Outlook

- High debt and low nominal growth leave risky assets hostage to the Dollar

- Deflationary policy error can rapidly lead to spiraling declines in risky assets

- The Fed has pulled back from a deflationary error, but with policy likely to remain broadly in "neutral" don't expect much of a reflationary tailwind either.

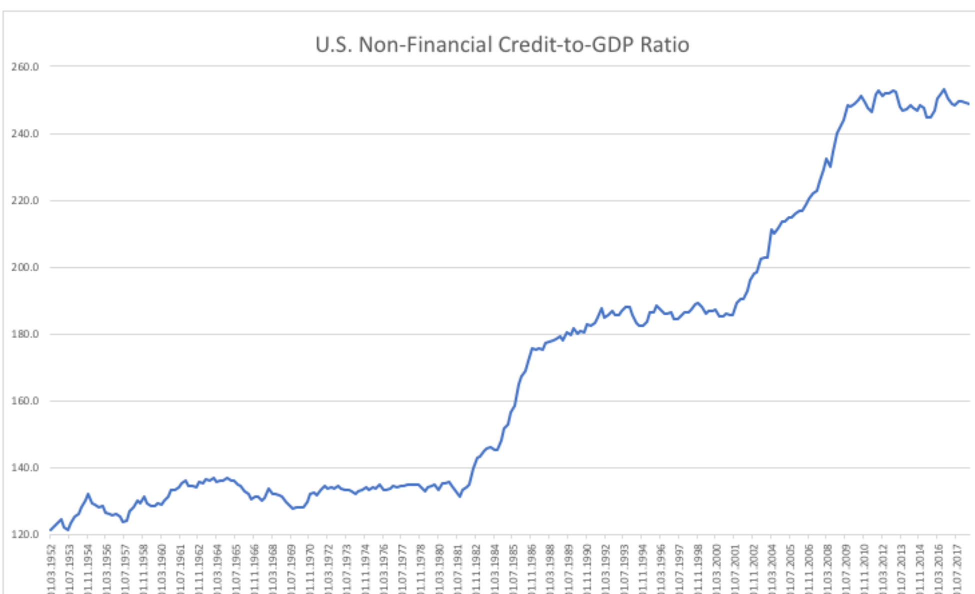
- The central tendency for risky assets is "good, not great" amidst low volatility *assuming U.S.-China trade talks stay on course*.

High Debt Levels

- While it's an article of faith that we have "high debt levels," we should be respectful of the fact that we don't exactly know what constitutes "high."

- Furthermore, debt-to-GDP compares a stock to a flow. To asses an economy-wide leverage level we should really be comparing debt to the "value of the U.S. economy" (akin to an equity) rather than to GDP (akin to its earnings).

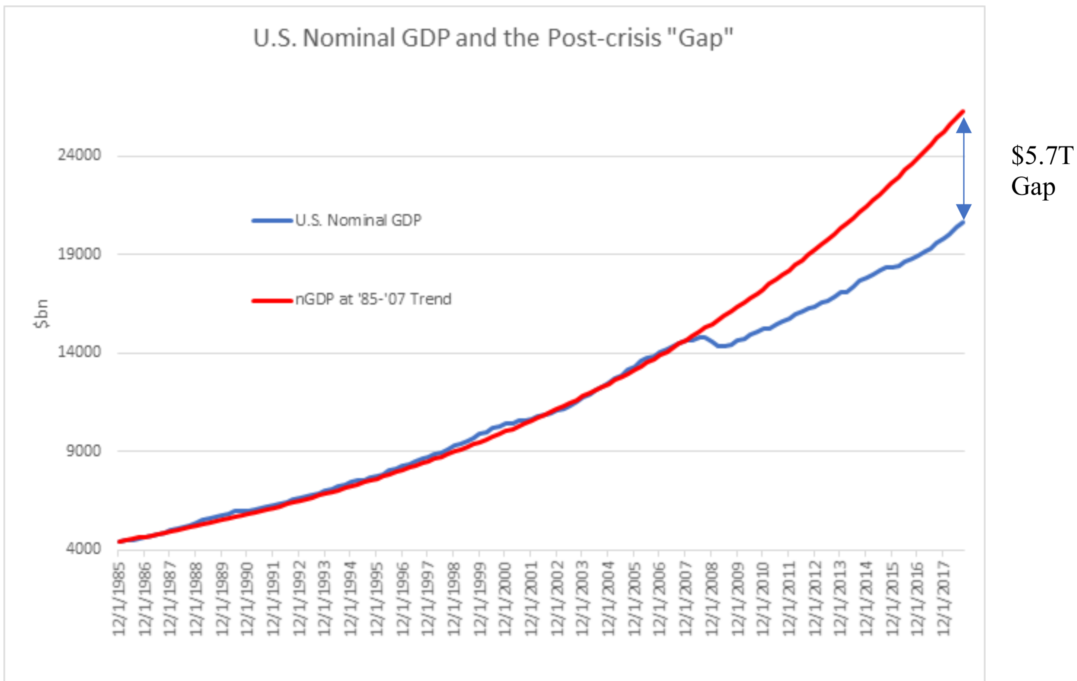
- Caveats aside, the market's hypersensitivity to deflationary policy error is suggestive of debt levels being "high"



Low Nominal Growth

- Even if debt levels had been optimal in 2007, the break in trend nominal GDP growth would render them "high" today

- If credit market participants in 2007 had extrapolated the 1985-2007 trend growth rate of nominal GDP as their baseline for the economy's debt-carrying capacity today, they would have over-estimated by $5.7T.



- We've all heard the term "inflating away the debt." We've done the opposite. We've swelled it by allowing nominal growth to downshift dramatically.

- Again, if we think of the economy as a stock, its "value" could be thought of as the NPV of its future nominal GDP stream. Lower future nGDP = lower "equity value" for the economy = higher "debt / equity ratio."

- Debt-to-GDP is flat since the financial crisis. But ***if nominal GDP growth has permanently downshifted, the economy-wide "debt ratio" as properly conceived (debt/equity value) has risen substantially.***

- So yeah, we probably have "high debt."

“High Debt” and “Dollar Dominance”

- Investors often bemoan the fact that “everything is about the Fed.” This is exactly as one would expect if the economy were battling with a barely-supportable debt load.

- It’s not just currency-mismatched Dollar-debtors who are stressed when the Dollar rises (although their problems may be more visible and immediate).

- A sharp rise in the external value of the unit of account is a logical precursor to an internal rise (deflation). Creditors don’t wait until that shows up in government-issued inflation statistics to embed additional risk premia in at-risk credits.

- Tight money / strong Dollar + high debt loads = risk of debt-deflation (a self-reinforcing spiral). As I described in “Fed Memo: You Had One Job” (12/18/18), the Fed has been dancing along this precipice since mid-2014.

Financialized Money-Creation

- Debt-deflation risk is compounded by another self-reinforcing cycle: that between liquidity conditions and asset prices.

- Interbank and asset-financing markets are hyper-regulated and remain counterparty-skittish.

- The liquidity (“moneyness,” not bid/offer) of trillions of Dollars of financial assets is reliant on repo haircuts, rehypothecation chains and other bank financing terms.

- In a “risk-off” environment financing chains compress and terms tighten, reducing systemic liquidity, putting upward pressure on the Dollar (the predominant funding currency), causes further deterioration in sentiment and liquidity terms in a vicious cycle.

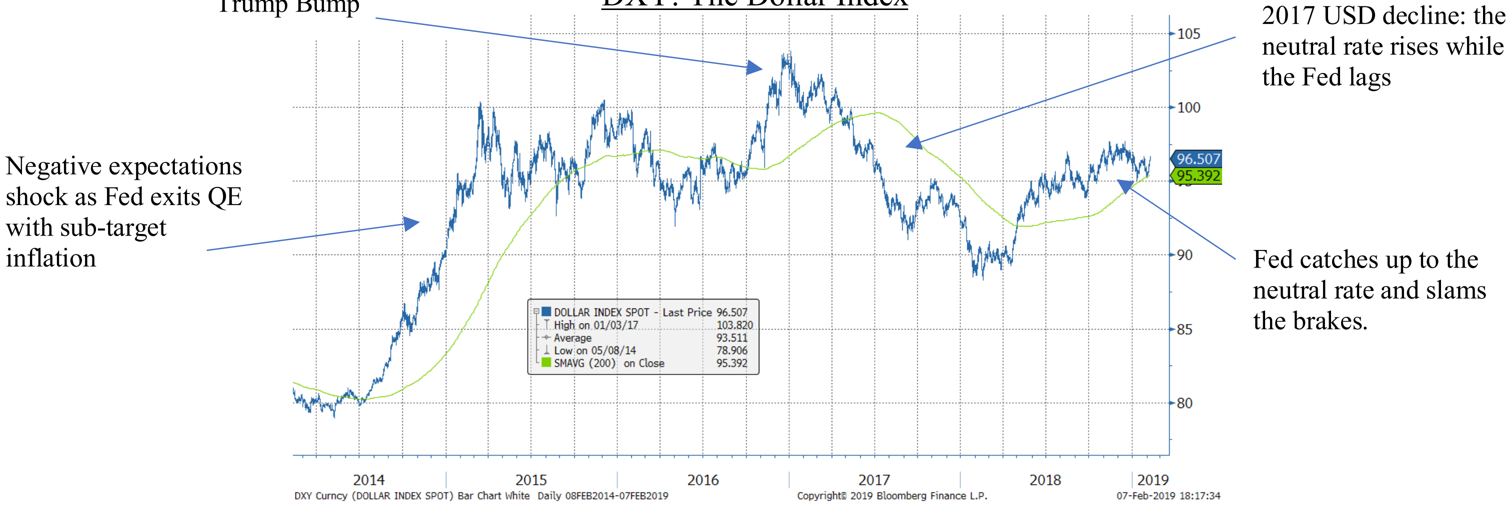
- In a “risk-on” the cycle is virtuous: liquidity brings asset reflation which brings more liquidity.

- This exacerbates the hypersensitivity of asset markets to Fed policy. We can bemoan the fact that “everything is about the Fed,” but it just is.

Neutral Sounds Nice

- If we presume the Fed is holding the Funds rate at a level that is close to "neutral" we should anticipate dampened volatility as debt-deflation fears subside and financing conditions remains stable. These self-reinforcing cycles should remain dormant until the Fed again moves into either the reflationary or deflationary error zone.

DXY: The Dollar Index



Has the Fed avoided deflationary error?

- The Fed made a critical shift at Jan. FOMC into "whites of the eyes of inflation" mode ("Powell Stumbles Home," 1/30/19).

- This doesn't preclude the possibility that they've already gone too far, baking recession into the cake.

- I discount that likelihood. Lets' survey some indicators…

- The Yield Curve continues to signal that the Fed has gone to the edge of policy error but not yet over it. I doubt the Fed will actively invert the curve, but an external shock could push this indicator into the danger zone:

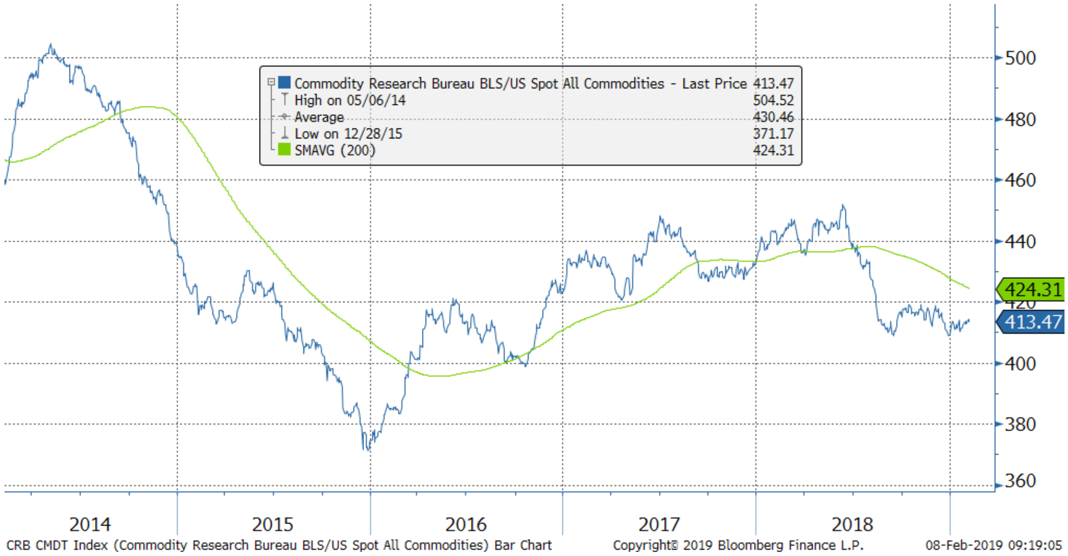
U.S. Treasury 10y-2y Yield Curve

- Inflation break-evens show signs of relief:

Federal Reserve 5y-Forward 5y Inflation Break-even

- Commodities remain moribund:

CRB Spot Index



- High-Yield has come ripping back:

CDX High-Yield 5y Spread

- It's a mixed bag for market-based indicators of liquidity conditions, but we can definitively say things have stopped getting worse

- There is one indicator (which happens to be my preferred) that is an outlier. Gold prices are suggesting of relatively healthy liquidity conditions:

Gold Price

- The confluence of a strong Dollar with higher gold prices could be indicative of the Dollar winning "prettiest in the ugly contest."

- To the extent that DXY strength is the result weakness in the basket of counterpart currencies, that DXY strength would not be suggestive of Fed error and is a less ominous indicator for risky assets.

Conclusions:

- High debt and asset-based money creation leave markets hypersensitive to any deflationary policy error

- The Fed pulled back from the brink of just such an error

- With Fed Funds near neutral and the neutral rate itself under no obvious pressure, the base case is for neither deflationary nor reflationary forces to bear on asset markets

- This is suggestive of "normal returns" for equities, and relatively safe coupon-clipping in credit and EM carry, *assuming the U.S.-China trade talks do not go off the rails*.

…Back next week with an update on the trade talks.

Sneak preview: the market is far too complacent on the prospects of Trump capitulating.