Thoughts From The Front-line

Why August’s News Could Propel Global Liquidity Far Higher

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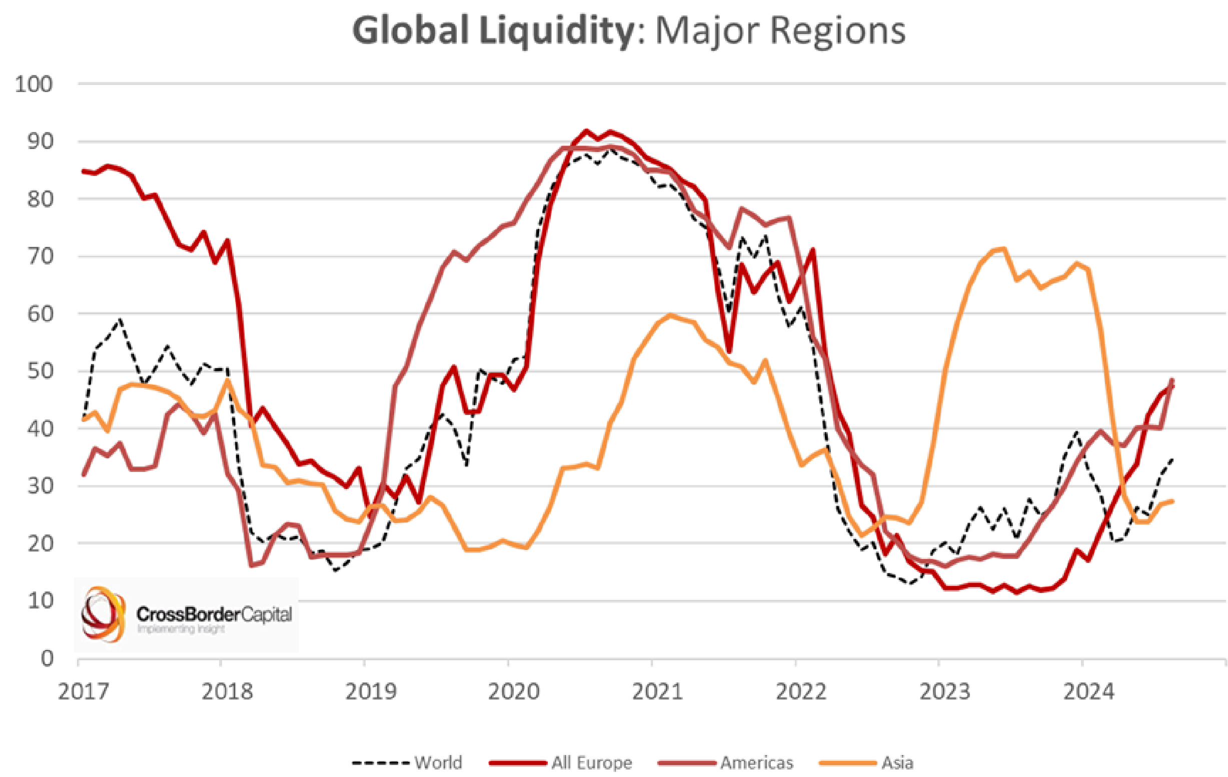
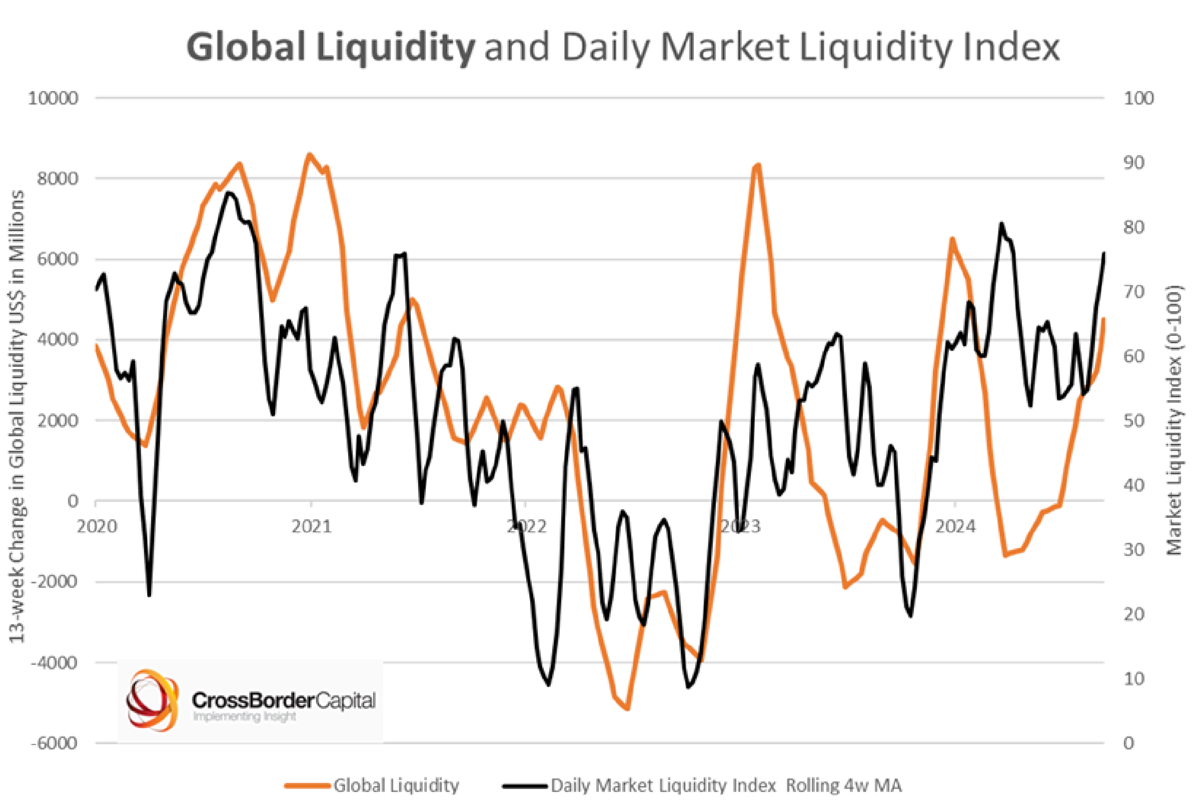
Our take on investment markets remains positive and unchanged. **Despite a gathering gloom among investors as markets continue to climb a ‘wall of worry’, there is much to like from a macro-standpoint:** World policy makers are seemingly eager to further ease monetary policies; the US economy appears slow, but not recessionary, and the deflationary Chinese economy is likely to keep a lid on World inflation. On top, we read into the Yen’s recent jump some ‘deal’ potentially agreed between the US, Japanese and Chinese authorities to weaken the US dollar slightly, thereby allowing Global Liquidity to expand further and giving a hard-pressed China the window to add vital liquidity to her markets.

The chart below splits Global Liquidity by major region, using our proprietary GLI™ family of indexes. Asia, which is dominated by the Chinese economy, is plainly trailing the Americas and Europe.



Although the GLI index is still some way below its likely future peak in late-2025, the nominal value of the Global Liquidity pool at US$174.3 trillion is itself hitting new records. Improvements in funding conditions are already helping to deepen market liquidity as highlighted in the chart below. This uses latest estimates of the weekly change in Global Liquidity and compares them to an index of market liquidity, made up of daily bid/ ask spreads, volatility and transaction volumes. **On both counts, liquidity is improving.**

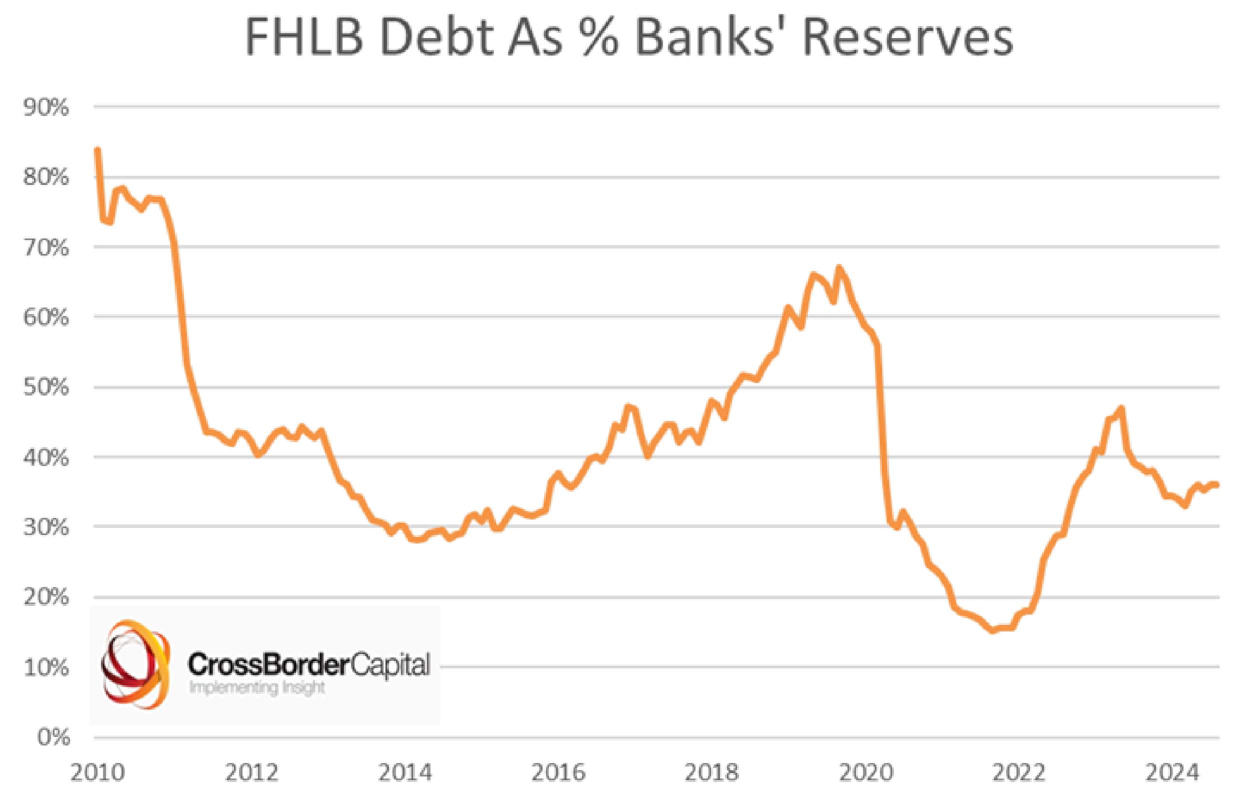


One corollary is that without a Chinese economic locomotive, Western policy makers will be forced to remove the monetary brakes and add stimulus to revive their sullen economies. **Consider, the 1997/98 Asian Crisis as precedent.** Therefore, the Global Liquidity Cycle, particularly the Advanced Economy index sub-component, is slated to continue advancing towards its likely peak in late-2025. We have previously cautioned that further asset market gains, following the GLI index bottom in October 2022 (or nearly two-years ago) will become harder. **Nonetheless, we remain positioned 'Risk On' and look to rotation, both internationally and towards later cycle industry groups within portfolios.**

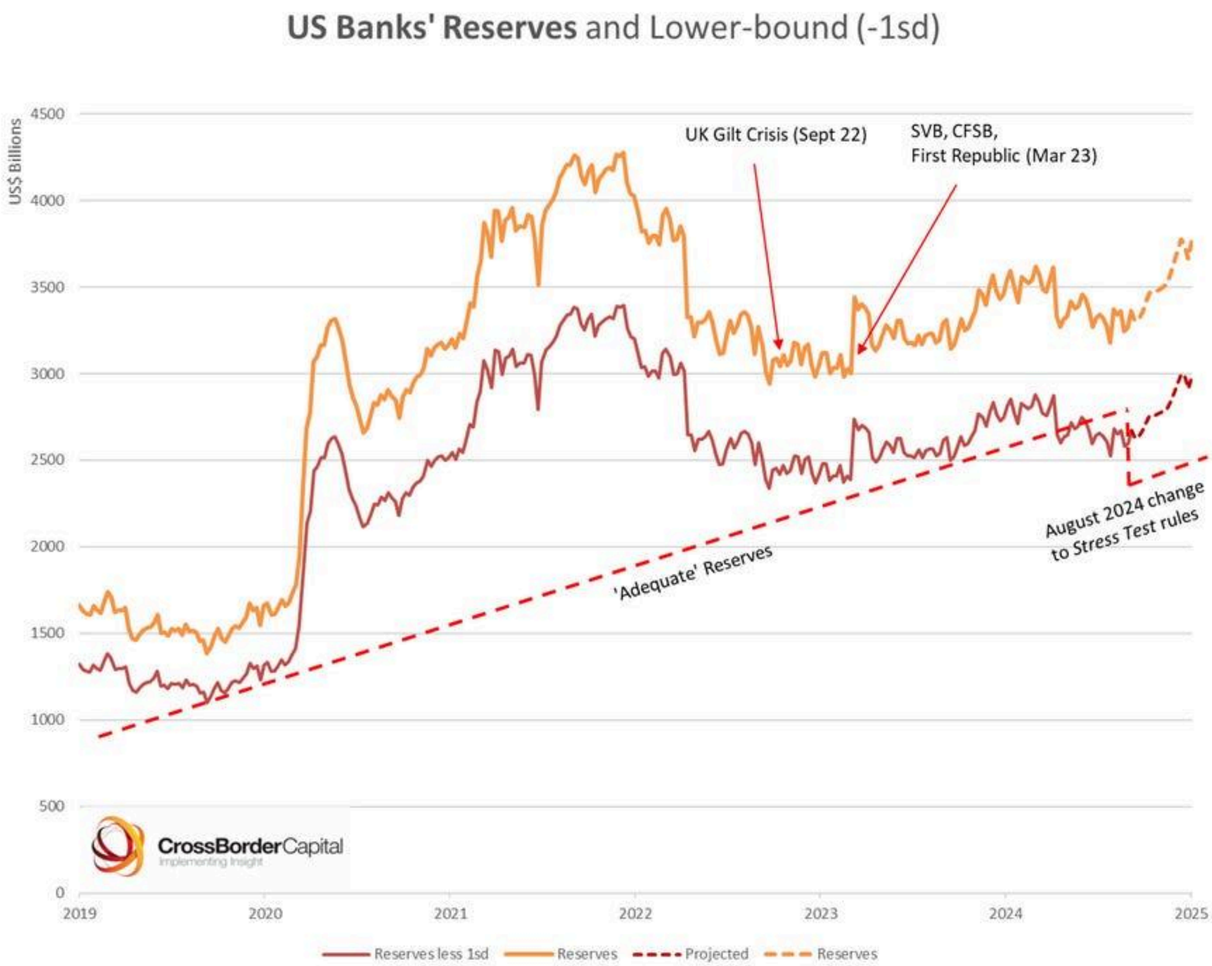
Events in August harden our conviction. We recently commented that a key issue for investors is the fast-approaching re-imposition of the ceiling on the size of the US Federal debt stock from 2/1/2025. This event is made more acute by the ‘failure’ of two recent Treasury auctions. Deep set annual fiscal deficits of some US$2 trillion will plainly require considerable new funding.

In this light, last month may prove a watershed in helping to ease funding tensions. On Tuesday, August 13th, the Federal Reserve Board published a crucial FAQ on banks’ internal liquidity stress tests (ILSTs). Large bank holding companies (those with over US$100 billion in assets) are required by regulation to conduct these ILSTs, over different time horizons and report the results to their examiners at least monthly. The US Fed will henceforth allow banks to include access to the *discount window*, borrowings from *Federal Home Loan Banks* (FHLB) and the *standing repo facility* (SRF) in future stress tests.

FHLBs are outside the US Fed, but as *Government Sponsored Enterprises* (GSEs) they constitute part of the Monetary Authority and they can provide emergency funding for credit providers. Evidence their impact in the following chart, which measures FHLB debt issues as a percentage of banks’ reserves held at the Fed. They play a growing role in liquidity provision and were especially active during the March 2023 SVB Crisis.



Changing the *Stress Test* rules will incentivize banks to hold fewer precautionary reserves at the Fed and instead switch funds into Treasury collateral, and potentially even into commercial loans. Although it is hard to quantify its precise impact (we suspect at least US$500 billion) the direction is unambiguous. **As a result, US money markets should, in future, be able to operate smoothly on an overall level of bank reserves somewhat below the current US3.3 trillion.** (*Spoiler alert:* those who claim bank reserves are the only liquidity metric worth monitoring are about to get a rude surprise). Evidence the next chart, where the one standard deviation lower bound on banks' reserves tries to capture the 'tail' of smaller regional banks, i.e. those most vulnerable to liquidity shortages



US Banks' Reserves and Lower-bound (-1sd)
US$ Billions
4500
4000
3500
3000
2500
2000
1500
1000
500
0
2019
2020
2021
2022
2023
2024
2025
UK Gilt Crisis (Sept 22)
SVB, CFSB,
First Republic (Mar 23)
'Adequate' Reserves
August 2024 change
to Stress Test rules
CrossBorderCapital
Implementing Insight
Reserves less 1sd
Reserves
Projected
Reserves