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# DOLL'S DELIBERATIONS

WEEKLY INVESTMENT COMMENTARY

## Liquidity Boom Won't Last Forever

After a brief consolidation post-Labor Day, global equities have pushed to fresh highs, extending what has been a solid year. Strong earnings have provided underlying support. The drop in bond yields (before the recent run-up) on the back of even more dovish central bank news (including the about-face from the BoE on lifting policy rates and rumors of a potential replacement of Powell for an even more dovish Fed Chair prior to President Biden's re-nomination of Chairman Powell), also benefitted risk assets. Risk-taking has been heavily incentivized by extreme monetary and fiscal reflation and massively negative real interest rates. Stocks historically rise until real interest rates become restrictive (which has historically been higher than 2%) and choke out weak sectors of the global economy. This relationship broke down in the 2010s since ultra-accommodative and previously scarred central banks anchored policy rates near zero, subsidizing growth and asset price inflation. Persistent deleveraging and fiscal austerity in the U.S. and Europe helped to keep inflation depressed. The distortion has been amplified even further since the pandemic, with central banks (led by the Fed) abandoning their traditional targets to maintain extremely easy policy settings to set a goal of encouraging above-target inflation.

Central banks have effectively created an environment where there is no alternative to buying risk assets, while they, along with fiscal authorities, have provided a massive wave of liquidity to be put to work. There has been no shortage of issues that investors have been worried about over the past 18 months, including COVID-19 waves and lockdowns, the Chinese growth slowdown and policy missteps, as well as supply bottlenecks and surging costs. Yet, the flood of excess liquidity has helped prevent even minor corrections in major equity markets, excluding China.

The challenge for investment strategy is that most asset classes have been bid up to full or higher valuations, including equities, government bonds, credit, commodities, and some real estate markets. Deeply negative real bond yields and the massive re-rating in forward P/E ratios (especially among U.S. growth stocks) provide a message of bubble tendencies across asset classes.

The landscape is shifting, as the wave of global liquidity is starting to crest, although it will still be plentiful for the foreseeable future. It is difficult to fully capture the amount of liquidity available to support financial asset markets. However, (1) U.S. broad money (M2) experienced an unprecedented surge due to the pandemic-related policy response. Measures of liquidity are now peaking relative to GDP and cooling on a rate-of-change basis. (2) The Fed has begun tapering its balance sheet, which has doubled since early 2020 and provided significant support for fixed-income assets. Indeed, the Fed now owns about 30% of outstanding Treasury securities. The Fed's balance sheet will continue to expand through mid-2022, but peak relative to GDP and slow on a rate-of change basis. (3) The U.S. government has provided unprecedented fiscal stimulus, with much of the expenditures so far being in the form of transfer payments to the household sector. This has led to a massive surge of more than $2 trillion in excess household savings (about 10% of GDP), which in turn has helped support asset markets. However, the transfer payments have already been made. Excess household savings has peaked relative to GDP and are likely to erode in favor of ongoing consumption as the economic expansion continues.

Aggregate liquidity conditions will remain plentiful for a long time, providing underlying support. However, as the massive liquidity boom fades, some of the frontier segments of global assets markets are likely to be vulnerable. Not all asset classes will continue to be bid up when there is no longer an ongoing massive flow of new liquidity searching for a home. The priority among asset managers is likely to also shift from the need to put fresh money to work, to refocusing on optimizing allocations of existing capital. Asset allocation will gradually return to the forefront, financial market volatility will increase notably, and a greater dispersion will occur between the winners and losers.

We remain more constructive on the economic outlook than the consensus, and do not perceive any end of cycle threats currently on the horizon that would lead to a sustained period of risk-off. However, unprecedented events over the past couple of years have led to an abnormal decoupling of the policy, economic, and investment cycle. Global authorities have forcefully separated the policy cycle and bond pricing from the economic cycle by deliberately lagging economic growth and inflation by a duration and magnitude that they have not done in modern history. In turn, this has encouraged equities and other risk assets to materially outpace improving underlying fundamentals.

Our view has been that U.S. core consumer price inflation will prove stickier than most anticipate. Indeed, U.S. core CPI inflation spiked even further in October to an annual rate of 4.6% and is unlikely to ease much this holiday season as retail inventories remain low and consumers are expecting/willing to pay up to obtain desired goods and services. While strong demand is playing a major role in supporting inflation, some of the current spike is due to base effects and temporary supply bottlenecks. Still, our view has been that when these wear off, core inflation is more likely to return to a 2.5% to 3% pace, rather than 2% or lower as is generally expected by investors.

## CONCLUSION

The U.S. economy will put persistent pressure on the Fed to speed up its policy normalization path. In turn, this should help steadily lift bond yields. We are not changing our generally constructive investment stance at this point, but we are expecting increased financial market volatility as the wave of liquidity fades, growth conditions moderate, and bond yields rise. VIX futures and other implied volatility measures are likely to spike periodically unlike what has been the case for much of the past 18 months. The cyclical bull market for risk assets will persist, fueled by solid growth and easy/lagging policies. However, not all asset classes will continue to win in absolute terms and greater selectivity will be required, with more muted overall gains.

## INVESTMENT OBSERVATIONS

1. Easy money in 2021 has been made
2. Strong economic and earnings growth peaked in Q2
3. Inflation is the key issue
4. Washington uncertainty regarding spending and taxes continues
5. International hotspots increasing (Iran, China, Russia)
6. Correction likely at any time (10% decline happens on average once a year) – big equity declines unlikely with such strong economic and earnings momentum.
7. Stocks > Cash > Bonds over next 6-12 months
8. Value > Growth / Cyclicals > Defensives
9. Spread products to outperform Treasuries
10. Consider slowly adding to international positions

In summary, the stock market is in a tug of war…

Ongoing Positives

- Above-trend economic growth
- Above-trend earnings growth
- "Pedal to the metal" policy still on
- Low interest rates
- T.I.N.A./F.O.M.O

Creeping Concerns

- Inflation NOT all transitory
- Fed on slow bearish path
- Threat of higher interest rates and lower stock multiples
- Fiscal circus in D.C.
- Earnings growth slowing – Q2 +90%, Q3 +39% (Est)

…which leads to choppy markets with higher volatility in both directions.

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