

# Market Outlook

## March 2007

Andre Ratkai, CFA President  
Praxis Advisory Group, Inc.

### Lust for Liquidity

Over the last few months, the debate raging on Wall Street has been over "liquidity." The debate is not merely academic, but an effort to explain why the stock and bond markets are behaving the way they are. The current stock rally from the summer lows is the longest stretch since the 1950s without so much as a 2% decline. (As of this writing, stocks swooned 3-4% on February 27<sup>th</sup>, causing a February newsletter to become a March newsletter. More on that later.)

The bond market has also defied the conventional wisdom of how it "should" behave, as higher inflation and energy prices have failed to send yields soaring as feared. Alan Greenspan called the weird behavior of bonds a "conundrum." Ben Bernanke, the current Federal Reserve chairman, pointed to the "global savings glut" as the primary driver of asset prices. The concept of "liquidity" is being used to explain everything from the real estate boom to rising stock prices to falling bond yields.

What exactly is "liquidity?" You only have to look in your wallet to come up with the most pedestrian definition. If you have \$2.00, you're not very liquid at the moment; \$2000 will count you among the nicely liquid, however. In the world of securities, the ability to buy and sell easily without triggering big changes in prices implies liquidity; shares of IBM can be sold any moment of the trading day; a parcel of real estate cannot.

The liquidity that is causing the most brain-teasing today is a balance sheet concept: the share of money (or things that can be exchanged for it in a hurry) within the assets of households, firms and financial institutions.

This last type of liquidity has come from several sources since the new century began. Closest to home, the ability

of homeowners to borrow against the equity in their homes has created liquidity, which may have been spent on everything from big-screen TVs to medical bills.

Another source is our trade deficit with foreign countries, notably in Asia and China. The import of goods from other countries must, of course, be paid for. For example, US dollars are converted to Chinese *yuan* to pay the Chinese exporter. But Asian exporters have simply "recycled" much of these funds back into US Treasury bonds and probably the stock market. This has had the effect of pushing up asset prices beyond where economic fundamentals alone would put them. Asian balance sheet liquidity has helped everyone's 401k in that sense.

A third source of liquidity is from oil exporters. They have had a once-in-a-generation windfall since the start of the Iraq war in 2003, as oil prices have rocketed to \$75 a barrel (currently at \$60). This huge transfer of wealth has caused a stock market bubble in the Middle East (yes, they do have stock markets there), but also has been

recycled into US bonds, stocks and real estate.

In the good old days, the huge liquidity flows described above would have had economists fretting about "too much money chasing too few goods," and guarding against the resultant price inflation. Today's global economy is characterized by overcapacity and oversupply of goods in most industries. Like the old Prussian generals on the eve of WW I, economists are fighting the

wrong war. Inflation today is in assets, not in goods prices.

The real estate boom is an obvious example of this phenomenon. The liquidity that allowed creditworthy borrowers to get cash out of their homes and refinance multiple times spilled over into the "sub-prime" strata of less than creditworthy borrowers. They were offered terms they couldn't refuse: 100% loan to value loans, 3%



mortgage rates, and 50-year payback periods. Unfortunately, the merry-go-round stopped when sub-prime borrowers began to default, homes were foreclosed upon, and used homes were forced upon the market. The liquidity dried up, creating a market retrenchment.

Similar phenomenon are occurring in the world of money. The yen "carry trade" is the technique where an investor borrows in Japanese yen at near zero interest rates, and invests the borrowed money in US Treasury bills or bonds. The spread between the interest rates has been a big source of profits. Thus the borrowed funds provide liquidity to the financial markets.

But this can only work under two scenarios: falling interest rates, or stable interest rates. These conditions have certainly been present lately, but cannot persist forever.

Derivative securities are the great unknown factor in finance today. A derivative is a security whose return depends in some way on another security. There are far too many variations of derivatives to list here. Suffice it to say that the current environment has encouraged risk-taking beyond what economic fundamentals may justify. As long as everyone doesn't call for their money at once, the "systemic risk" of the derivatives markets should be under control. But if investors try to cash in at the same time, expect there to be a financial accident of some renown.

You see, the common thread through the liquidity examples above is borrowing. Liquidity has been created largely through borrowing against the balance sheet. Whether it is the householder leveraged to the hilt with mortgages and credit cards or the US trade deficit (these are two sides of the same coin!), the yen carry trade, or the growing popularity of "private equity" deals (leveraged buy-outs under a new label), borrowing feeds the liquidity machine we are experiencing today.

### The Chicken and Egg Conundrum

The important question for investor is "What happens when the liquidity dries up?" for it likely will. Liquidity ebbs and flows, based partly on expected returns from an

asset, and partly on psychological factors. If future returns are expected to be low since prices have risen, liquidity will flow to other areas (including bricks-and-mortar physical assets, not just paper ones). If fear overtakes the appetite for risk, capital will similarly flow away. This happened with the emerging markets boom of the early 1990s and the dot.com bust of the early 2000s.

The chicken and egg question is whether ebbing liquidity causes asset prices to fall, or do falling asset prices cause liquidity to dry up? Ultimately, the cause probably isn't as important as the feedback loop that can be created. Just as higher asset prices reinforce the inflow of liquidity into an asset class, a negative feedback loop is created as lower prices and less liquidity feed on each other. For

investors, therefore, the cause isn't nearly as important to understand as the effect.

So let's get back the dramatic decline of February 27<sup>th</sup>. Should we be worried about the message the market sent that day? The message of the market is more like poetry than an instruction manual. It is subtle and aloof, and takes time and patience to understand. Thus, it is too early to tell whether the 400-

point drop in the Dow Average is a harbinger of further declines to come. Paying attention at times like these is exactly what Praxis clients are paying for.

Moreover, the best early warning system to identify liquidity problems is in the portfolio itself. By using a combination of relative strength and trend following techniques, problem securities can be spotted much earlier than relying on fundamental analysis alone. This applies to the more positive pursuit of buying securities also, as future leaders often behave much better than the crowd, especially in stressful markets. The focus remains on security selection to determine which assets will thrive, or wither, under any market conditions.

Wall Street's lust for liquidity seems to have taken on epic proportions, reminiscent of past booms. Now, as then, independent and disciplined management will serve clients far better than betting that the liquidity spigot will be open forever.

