Beneath the Surface

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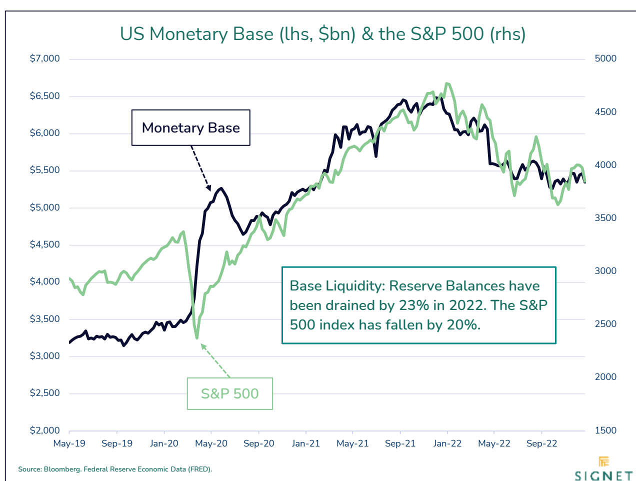
SIGNET

Into 2023: Liquidity – the Market's Oxygen

- We are cautiously positioned going into 2023, and this reflects our concern that the global economy may enter a recessionary period. If inflation was the focus of 2022, we suspect that concerns for global growth will be the focus for 2023. The rapid expansion of credit in response to the Covid-related emergency, and the exogenous supply shock relating to the crisis in eastern Europe, have left the global economy in a precarious state. The consequences from an increase of $8.2 trillion (35%) in US total public debt over the last two years were euphoria in 2021, an inflation shock in 2022, and – we believe – something potentially more sobering for 2023.

- Central bankers must restore their credibility by bringing inflation expectations back down, and to do that they must continue tightening monetary policy and hope for a 'soft' economic landing. There certainly appear to be clouds on the horizon: in the US, the National Bureau of Economic Research (NBER), which formally declares recessions, has four of its six dominant economic measures flashing caution; only the two employment measures remain at levels indicative of healthy expansion. We suspect that central bankers' resolve will be tested in 2023 as corporate earnings contract and over-leveraged institutions, the ones often lurking in the shadows, struggle to cope with the cyclical shift in economic and financial conditions. If there's a downturn in 2023, we now need to understand its potential characteristics: its scope, severity and longevity.

- While the spotlight is firmly on the Fed's interest rate policy and quantitative tightening - the reduction of its balance sheet - it is also important to monitor the detail that exists on the 'liability' side of the Fed's balance sheet. Reserve balances are the largest constituent of the monetary base and a key proxy measure of funding 'liquidity' and risk appetite. US monetary policy is currently focused on the interplay between interest rates, the liquidity channel and aggregate economic impact. The liquidity channel is the key mechanism through which reserve balances are effective. The Fed will maintain an ample reserves regime, but these reserves – base liquidity – are being partially drained through the quantitative tightening process. If liquidity is the market's oxygen, we can begin to understand the economic and market impact of the Fed's actions – the S&P 500 is highlighted in the chart below alongside the US monetary base. The draining of liquidity is due to continue into 2023, hence our general caution.



- Recent financial crises have highlighted the potential build-up of systemic risk arising from increased credit intermediation involving entities outside the regular banking system. These entities, collectively known as 'Shadow Banks' (formally Non-Bank Financial Intermediaries or NBFI), are significantly entwined within the 'plumbing' of the global financial ecosystem. Shadow banking is often associated with the money-market (short-term) funding of capital market (long-term) investing and, implicit within that, it is therefore vulnerable to market-based refinancing risk as liquidity is drained. Private markets, which are prone to overvaluation, optimistic assumptions, aggressive accounting and high leverage are an area we're mindful of, given their rapid growth in recent years. Private markets may exploit obscure valuations and illiquid pricing during episodes of abundant credit and low hurdle rates, but these factors may come back to haunt them during the tighter, more forensic times. In 1992, Hyman Minsky warned us of unstable financing regimes borne from periods of stable and prolonged prosperity. That warning for private markets is highly relevant in 2023.

Therefore:

- Remain defensively invested. Fixed Income: there are opportunities to target quality and liquidity.
- Equities: target quality but there's no rush. Commodities: target precious metals.

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