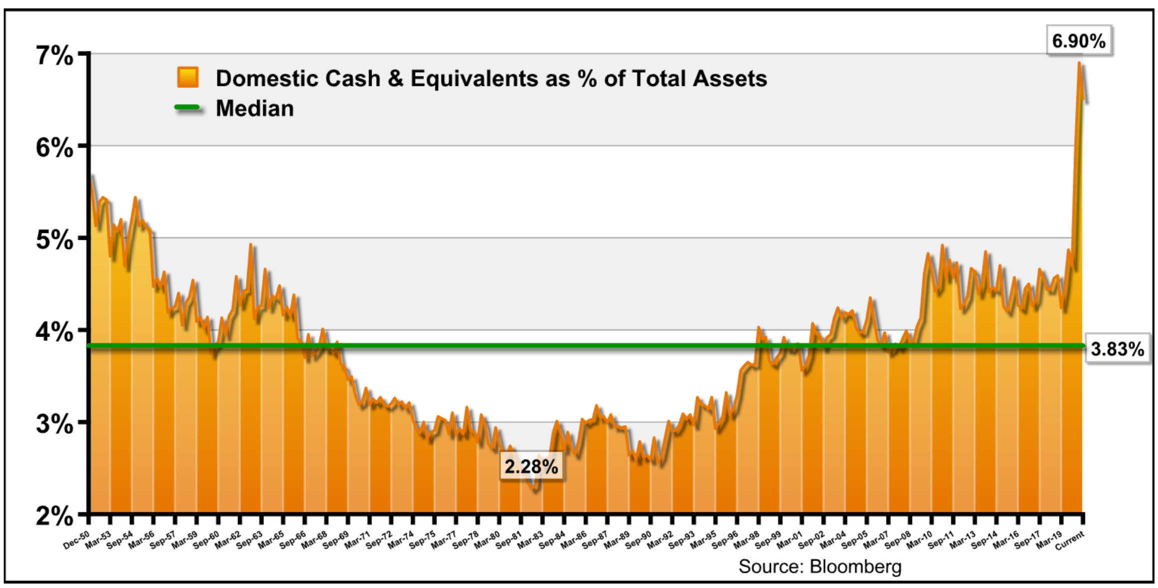
AAM Viewpoints – Liquidity: Historic Gains Lead to Marginal Drains
By Matt Lloyd

As we entered 2021, we believed the year's performances and allocations were heavily dependent on inflation and the recalibration many investors would have to take in an elevated inflationary environment. While still pivotal nearly halfway through 2021, we continually see a substantial discounting of an elevated inflationary market and will address the many layers that have occurred and what the sequencing of those will be throughout the rest of the year.

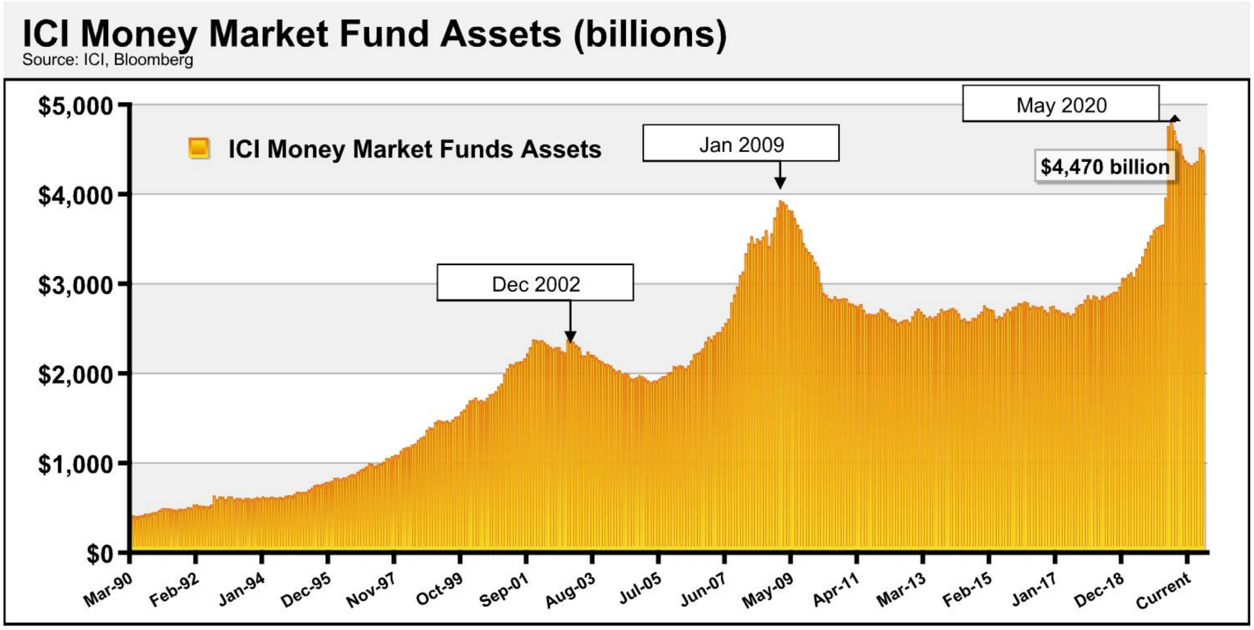
Only slightly less important has been the massive amount of liquidity in every corner of the economy and markets. We have discussed this and how it was a driver for the markets we currently are witnessing; however, there comes a point when we approach the top of the S-Curve (not to be confused with Scurvy) and marginal gains are best that can be expected. The economy is now getting traction, and this is represented in many economic numbers across the country which then leads to a draining of the excess liquidity in the system. We will look at the myriad of liquidity measures and what the draining from gains does to asset prices and fiscal and monetary responses.

First, we must always look at the household situation when this is nearly 70% of the driver of the economy. As Jim Costas mentioned last month, the levels of total cash equivalents in households is at all-time highs and approaching nearly $16 trillion in total. Perhaps the most telling statistic is the multiple rises in cash balances relative to debt. This is represented that nearly 97% of total debt on the household balance sheet is covered in some form of cash equivalent – a level not seen since 1990. The narrative of the debt-laden consumer and leveraged situation looks to be a legend much like saying "Beetlejuice" three times to make him appear. This at least is the case on the macro scale and not necessarily on the micro level where many households are still struggling from the pandemic-induced economic shutdown.

The following shows exactly what has been transpiring since the all-time high in interest rates in 1982 as well as what the last batch of stimulus payments have done to skew economic and liquidity metrics.

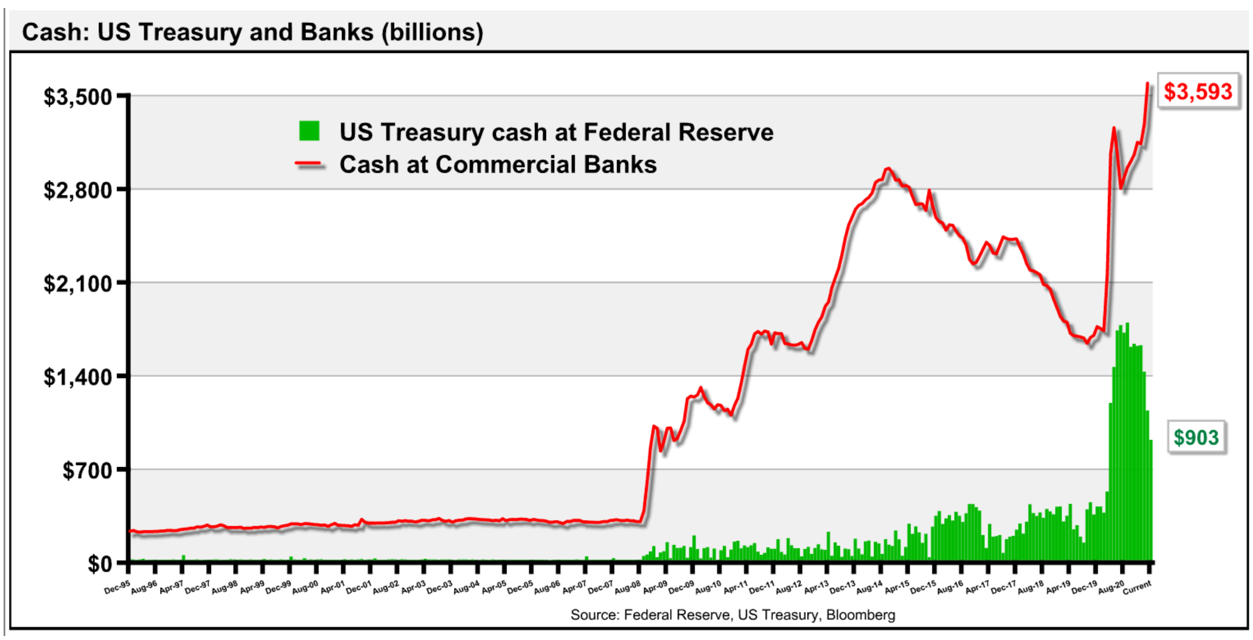


To be fair, this theory that excess liquidity will push consumption and asset prices might be true to a degree. However, there is also a relative floating level of cash positions that need to be met to appease the anxiety that households have had to deal with in the last two decades. In the last 25 years we have experienced currency crises, historic equity market corrections, rolling bear markets within a secular bull market, national housing crisis, a global bank run not seen in the modern era and a pandemic-induced economic shutdown that polarized the globe and paralyzed traditional economic theory.



In the last few months, we have seen an influx into the money market fund assets. We would expect this to decline as it has when economic recessions are past, and we begin to understand that we are in an early- to mid-cycle in most metrics.

The desire to elevate cash levels have been contagious…or necessary with anemic rates of return being offered. Banks and even the U.S. Treasury have been seeing elevated cash levels for some time, though for different reasons. Cash assets at banks now stand at nearly $3.6 trillion, an all-time high. For those curious why CDs (certificates of deposit) are so low and why you may have begun to hear talk about negative deposit rates, this is why. Consider it the antithesis of inflation in which too many dollars are chasing too few goods. Here we have way too much money chasing any rates of return which drives down the actual rate needed to offer to get an attractive rate.



Some other areas that are showing excess levels that could soon begin to drain are corporate cash for non-financial companies. Total cash equivalents for non-financial companies were up 47% in 2020 from 2019 to a total of $3.047 trillion, according to the Fed Flow of Funds. This will likely drain down over the next year in the form of stock buybacks as they approach the prospect of investing in new forms of business or rekindle the buyback of their own shares…even at current elevated levels.

The buildup of liquidity in the system was necessary, however, just like we tend to do, we go to excesses. The draining from historic levels will have reverberations in the economy and consequently in the market. However, it may flow to those areas where the risk and reward are more balanced. When markets are priced to perfection, perfect execution will only result in prices being maintained without a significant shift in optimism. While this will flow through the economy, we continue to stress the monitoring of the risk aspect as much as the reward.