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CAPITAL

Evidence of excess liquidity is everywhere

The famous 1955 quote by then Fed Chairman William McChesney Martin was that "The Federal Reserve… is in the position of the chaperone who has ordered the punch bowl removed just when the party was really warming up". This aligns with the view of most economists and politicians who see a role for central banks to reduce the peaks and fill-in the troughs through raising or lowering interest rates and more recently through quantitative easing. (Austrian minded economists believe central banks often accentuate the peaks and troughs with their actions and the evidence is generally with the Austrians on this.) Using the analogy today, central banks have switched from chaperone to alcohol distributor, repeatedly replenishing the punch bowl with an alcohol heavy mix when the guests are already trashing the venue.

The evidence of this excess is popping up everywhere and is obvious to everyone except the central bankers, even when the evidence is right in front of them. Just last week the Fed had over $500 billion parked with it overnight at a 0% interest rate with the amount growing daily. The RBA had $275 billion in overnight deposits recently with that likely to grow further as Term Funding Facility drawdowns end this month and banks are expected to fully utilise their limits.

The overflow of overnight cash snakes through to government bonds, with the Australian government recently issuing 3 month notes at -0.01%. In secondary trading, Australian 2 year government bonds have traded at -0.01% as well. Another notable example is Greek government bonds, with their 10 year bond yield now a measly 0.99% higher than German government bonds. Greece's government debt to GDP ratio has recently topped 200% and there's no plan for the country to get that down to anything manageable.

Moving out on the risk/return spectrum to credit and yield investments and we see the same pattern. US investment grade spreads are close to all-time lows and on an all-in basis (interest rate + spread) yields are far below historical levels. US sub-investment grade is similar with the spread component low and all-in yields at record low levels. The CCC bucket is particularly concerning with historically low spreads often combined with appallingly weak covenants. Another data point is European bank coco (hybrid) yields, which have also hit a record low. There are very few spots left in credit that aren't showing meagre returns.

In equities, most indices are setting all-time highs although there has been something of a pullback on high profile growth stocks this year. It's widely accepted that equities are reasonable relative value only if long term bond yields stay low and risk averse investors continue to be punished with negative real returns on cash and government bonds.

In venture capital there's been a record number of unicorns (companies breaking the $1 billion valuation mark) minted this year and we are only halfway through the year. The flood of SPACs is a big part of this, with hundreds of these time limited cash boxes creating a bidding frenzy for privately held companies. On the far end of the risk/return spectrum there are cryptocurrencies, non-fungible tokens and invisible artworks selling for crazy prices.

This brief tour of asset markets shows that the punch bowl should have been taken away, rather than being topped-up to overflowing. Central banks have history of not being able to see frothy markets and asset price bubbles until the wreckage is apparent, as demonstrated in the Tech Wreck and the Financial Crisis. Perhaps central banks need another metaphor to help them understand the current conditions; "when you find yourself in a hole, stop digging".

Written by Jonathan Rochford for Narrow Road Capital on 14 June 2021. Comments and criticisms are welcomed and can be sent to info@narrowroadcapital.com

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