

# The Illusion of Liquidity

By Dr. Marsha Vande Berg, [www.econvue.com](http://www.econvue.com), September 2015

*A lot can happen between 9 and 5!*

This advertising slogan was a favorite in the bygone days of nail-biting newspaper rivalry. It told the story of an underdog, a pm broadsheet that squared off with its morning competitor. The afternoon San Francisco Examiner needed to capture readership from the bigger and more influential Chronicle if it was going to keep publishing.

The strategy didn't work. The afternoon newspaper ended up on the block, and the morning paper is today a mere shadow of the influence it once wielded. The 9 to 5 slogan was clever, but it was a distraction too. It avoided the bigger threat on the horizon, namely the digital era and technology's capacity to do more with less and do it more efficiently.

I see these newspaper wars as analogous to what investors – whether individuals with 401Ks or pension funds and insurance companies with increasingly unmatched assets and liabilities – are facing. The risk is that they get sidetracked by the 9 to 5 implications of market volatility and overlook the longer-term implications of the unprecedented dynamics that are taking shape in today's capital and financial markets.

The end of an era of monetary easing by the world's largest economy is coming at precisely the same time that growth in China's economy, the world's second largest and which fueled booms in commodities and emerging markets, is coming up short.

What happens in New York and Shanghai, Beijing and Washington will have spillover effects worldwide. If that's saying the obvious, then what is still critical is understanding the size and extent of the spillover effects and the implications for liquidity in today's technology-driven, interconnected global marketplace.

Let's look at what happened in US equity markets in early September following successive days of unwinding on China's exchanges, misplaced market interventions by authorities there and then virtually on top of all that, a series of depreciations in the Chinese yuan and a decision to close the gap between the spot market and the central reference rate.

One widely held opinion was that inside China, authorities were reacting – and arguably over-reacting to the market gyrations because of worry about the risk of slowing GDP growth. Their efforts were intended to staunch a slide. With July export figures on a steep downward slope, it was asserted that this still export-dependent economy could not possibly grow at the advertized 7% of GDP.

But wait. There was more to the story, including context. While it was clear that a correction in China's equity markets was long overdue – when it happened, the overall value dropped nearly 40% -- so were equities trading on US exchanges overvalued, though clearly by not as much. Values of equities on US exchanges reflected a bull market run that was coincidental with the Federal Reserve's six years of quantitative easing.

If China had not been the catalyst of the correction in US markets, then something else would have, writes noted China scholar, Nick Lardy, in the August 25, 2015 editions of the *New York Times*. That's the explanation but still missing is the context.

Again, Lardy writes: "There remain concerns over Chinese real estate and state owned enterprises. But recent events should be seen as part of the conscious liberalization and rebalancing of the Chinese economy." There will be more to come, and this will impact the liquidity that is available in capital markets globally.

Liquidity, by definition, is what markets need to function smoothly. When markets have the access to capital they need on both sides of a trade, the buyer and the seller can conclude a transaction without causing an abrupt shift in price. Put another way, if an asset is priced fairly and market distortions are at minimum, then the value that is discovered can be counted on, at least for the intervening period and until circumstances change.

As we know several factors influence this process, and one highlighted more recently is the fading of the footprint and influence of big banks known as primary dealers. Under the Volcker rule of the 2010 Dodd Frank financial overhaul law, banks find themselves limited by commercial and regulatory pressures on how they use their capital to both make markets in securities and act as shock absorbers in times of market stress.

The *Wall Street Journal* in its Sept. 3, 2015 editions, pointed out that Morgan Stanley's average daily "value at risk" in the second quarter of this year was \$54 million compared to \$164 million in the same period a year ago. Goldman Sachs experienced a similarly-sized drop off in its trading risk over the same period.

What this means is that a significant amount of capital that once worked to set asset prices in the market now has to come from somewhere else, and that somewhere else may bring with it unnecessary risks. Modern-day investment systems such as hedge funds and mutual funds, for example, are lightly regulated and also tend to be less liquid than traditional banks.

Some see the crimps in liquidity flows as part and parcel of a structural change that is shifting the role of banks onto the shoulders of capital markets, and amplified by high frequency trading. Such changes will affect the quality and pace of accurate asset pricing for both equities and corporate bonds and by extension, financial stability in times of market stress.

Is this an instance where the regulatory pendulum has swung too far and/or the law of unintended consequences? It's too early to know answers, but it is certain that these circumstances are unlikely to shift any time soon. Quoting Mark Carney, the Bank of England's governor, the *Wall Street Journal* in its May 20, 2015 editions, described the change as plain and simple, a feature of the "new normal".

Additional indicators are multiple, and each is relevant for astute investment analysis, beginning with the divergent monetary policies in developed markets and the interplay between these policies and the central banks' domestic take on their economy's deflationary tendencies. "With the exception of Japan, disinflation has firmly set in in advanced economies," writes Phillip Hildebrand, vice chairman of BlackRock and former chairman, Governing Board of Swiss National Bank in a recent *Occasional Paper* published by the Group of Thirty, an organization of preeminent economists.

Meanwhile, secular/cyclical forces at work include demographics of aging societies; the unprecedented low price of oil; and pricing factors in technology at the end point of sale as well

as in the supply chain. And if this were not enough, there are also geo-political considerations at play.

There's worry about the implications of China's tactics in the South China Seas; Russian President Putin's unconscionable antics in the Ukraine, and incessant crises in the Middle East and recently, the waves of refugees into central and Western Europe. And then there are the gray and black swans which may not yet be visible but are surely swimming in our murky waters.

What is the upshot? If we track only the 9 to 5 issues, we may very well be headed for a surprise.

The worry is the "illusion of illiquidity", says Claudio Borio, head of the Bank for International Settlements Monetary and Economic Department in an August 24, 2015, interview with a European newspaper, the Boersen Zeitung. Investors might start to believe that there always will be enough liquidity to get out of the markets in time. This over-confidence fuels risk-taking and ultimately volatility, increasing the likelihood of market stress.

And so there is all the more reason for investors to keep their eye on the right ball.