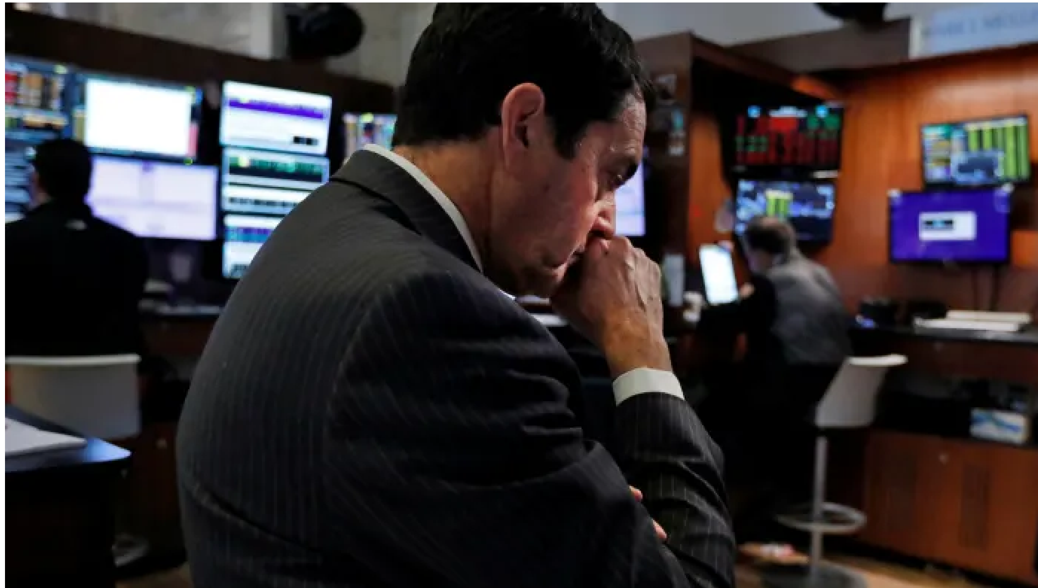
Opinion **FT Alphaville**

# A strong recovery could be bad for asset prices

Global liquidity will continue to pour into the world economy. But how will that impact asset prices and the recovery?



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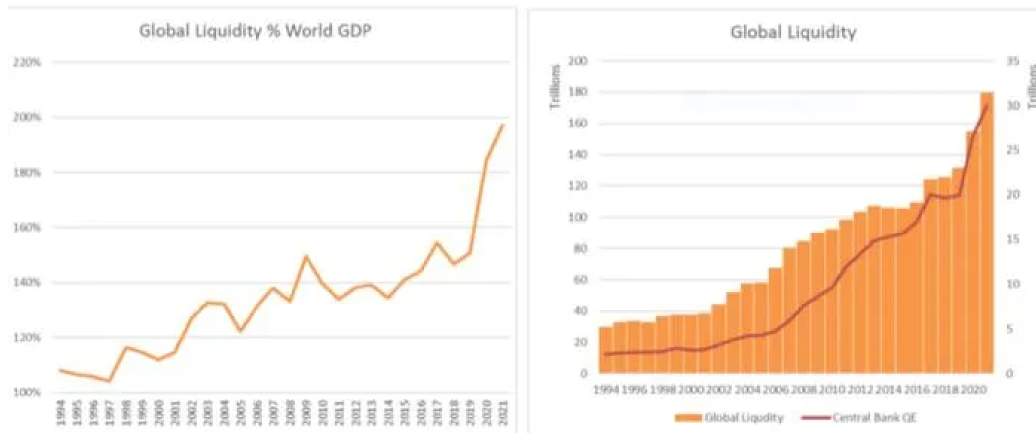
Guest post JANUARY 12 2021

*Michael J. Howell founded CrossBorder Capital, a London-based advisory and investment management company in 1996, and has published a book, Capital Wars on the turbulent rise of global liquidity. In this post, he argues that despite the pool of cash and credit available to investors breaking fresh records in 2021, global liquidity may prove to be more positive for economies than for asset markets.*

Money moves markets. Following the Covid emergency, huge amounts of new liquidity were pumped into the system by the world's central bankers and financiers to help support hard-pressed economies. These flows totalled a whopping $21tn, equal to a quarter of global GDP and paced by $6tn of central bank quantitative easing, or QE. Global liquidity looks set to rise by a further $15tn in 2021, with central banks already pencilling in a further $3-4tn of QE. By year-end, the stock of global liquidity is slated to test $175tn, or twice global GDP. Twenty years ago, global liquidity could only just match that total.

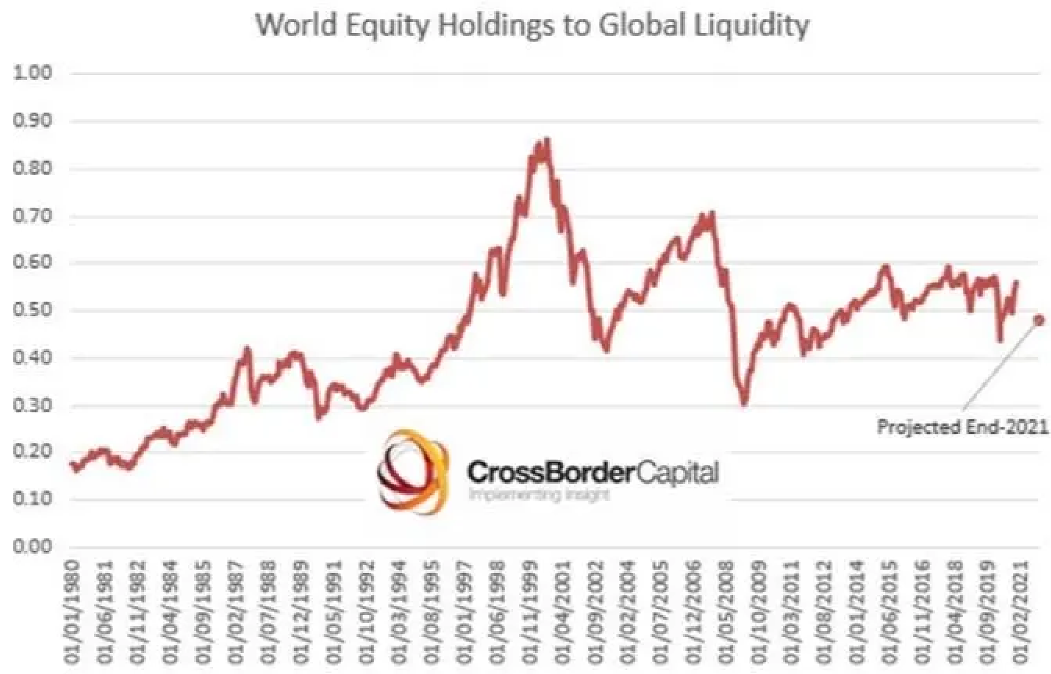



The geographical sources of new liquidity in 2021 will differ noticeably from last year, with Asia and emerging markets at the forefront. In 2020/last year, the eurozone supplied roughly one-third of the increase in QE and contributed much the same to rising global liquidity, even besting the US Federal Reserve. The Bank of Japan was also active, but because Japan's banking system made few new loans, this reduced the potential impact. The reverse was true for China, where a persistently tight People's Bank (PBoC) belied the contribution of one-fifth of the rise in global liquidity by Chinese banks and shadow banks. The anomaly can be explained by the PBoC's 'directed lending' instructions to China's State-owned banks. In 2021, we expect Chinese liquidity to contribute one quarter of the increase in global liquidity; the US to provide over one-third of new cash and emerging markets excluding China to jump to a significant 11 per cent share from barely 4 per cent.

Digging deeper into the latest data uncovers a sharp slowdown of net inflows into the dollar. US assets have been buoyed in recent years by several one-off factors. These are now fast dissipating. These include outflows from the eurozone following the 2010-12 banking crisis and capital flight from China in the wake of President Xi Jinping's anti-corruption drive. On top, many foreign banks bought US dollar 'safe' assets to satisfy new Basel III regulations. Looking ahead, Asia's capital account is now under better control, while cross-border capital has lately shifted back into Europe and seems likely to have an appetite for the upcoming and large-scale euro-denominated debt issues. If this points to future dollar weakness, it should further spur global liquidity higher simply by encouraging cross-border investors to borrow more, cheaper dollars.

So will we see the boom in asset prices witnessed over the second half of last year? Not so fast.

Despite the latest worries about inflated asset bubbles, the ratio between the sum of all equity holdings worldwide and this pool of global liquidity stands at close to 0.5 times, or only a tad above its long-term average. In 2000, the ratio stood at 0.85 times, and in 2008 above 0.7 times. It is important not forget its recent low. In the March 2020 market sell-off, the ratio suffered a bruising fall below 0.4 times. With hindsight, this proved an excellent buying opportunity.




Based on our projections, the prospective equity/ liquidity ratio for end-2021 stands at an undemanding 0.47 times. Surely this means that stock markets are still worth buying? Yet valuations are only half the story. Often far more significant for asset prices are fluctuations in the buying power of investors. Here's why it matters.

All money that is anywhere must, of course, be somewhere. But it is important to remember too that the economic system consists of not one, but two separate monetary circuits: a financial one and a real economy one.

Often the best time to invest is when policymakers are trying to stimulate sluggish economies. The second half of 2020 is a textbook example. When overall demand is weak, the financial circuit dominates. Last year, for instance, most of the new cash ended up in asset markets, sending stock prices higher and helping to push up home prices worldwide by nearly 10 per cent. But as economies recover, more liquidity will flow into the real economy, where most of us earn our livings. Already retail bank deposit accounts in Europe and America are surging higher.

How does that affect buying power?

When liquidity concentrates in asset markets, measures of so-called monetary velocity — calculated using the ratio of nominal GDP to money — fall. Conversely, when it starts to shift into the real economy, then monetary velocity rises. If velocity picks up, then there will — relatively speaking — be less cash chasing assets, and more capital invested in reviving the real economy.

In other words, buying power could shift from investors to consumers, leading to an economic boom. Counterintuitively, share prices could struggle to keep up.

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