

# Market bubble? Don't be so sure

Markets are less expensive than they look given all the money sloshing around, argues Michael Howell of CrossBorder Capital

All money that is anywhere must, of course, be somewhere. This simple truth explains why the \$50-odd trillion (roughly £35 trillion) of extra liquidity, injected following the Covid-19 lockdowns, has inflated global asset markets, sending share prices to new highs, causing house prices to spike, and putting a rocket under many commodity markets. For context, this sum is equivalent to more than the annual GDPs of the US and Europe combined.

We use the term "global liquidity" to emphasise that money is both international and also embraces wholesale-based credit-providers (the so-called "shadow" banks) that lie beyond the traditional, regulated high-street banks. This pool of fast-moving and footloose funds will again break records in 2021, fuelled by even more central bank quantitative easing (QE) as policy makers accommodate their continuing large fiscal (government spending) programmes (see page 18). In fact, global liquidity looks set to test \$180 trillion, or close to 200% of world GDP, having doubled as a share of GDP within the last two decades.

Macro-valuation shifts triggered by these swings in global liquidity drive asset prices. In other words, money moves markets. Although finance textbooks teach us that the value of a given asset is strictly determined by its expected future earnings, this is not entirely true. Total assets also have to match future expected liabilities in both size and timing. The hunt for assets to hedge liabilities is partly the result of increasing regulation and comes partly from the demands of pension trustees. Since holding cash does not do the trick, investors have to actively invest their excess liquidity in assets whose future values will at least cover these expected liabilities. This means that equities tend to be favoured in periods of rapid economic growth; "real" assets (such as gold and other commodities) are in strong demand during inflationary times, and bonds excel during periods of low inflation.

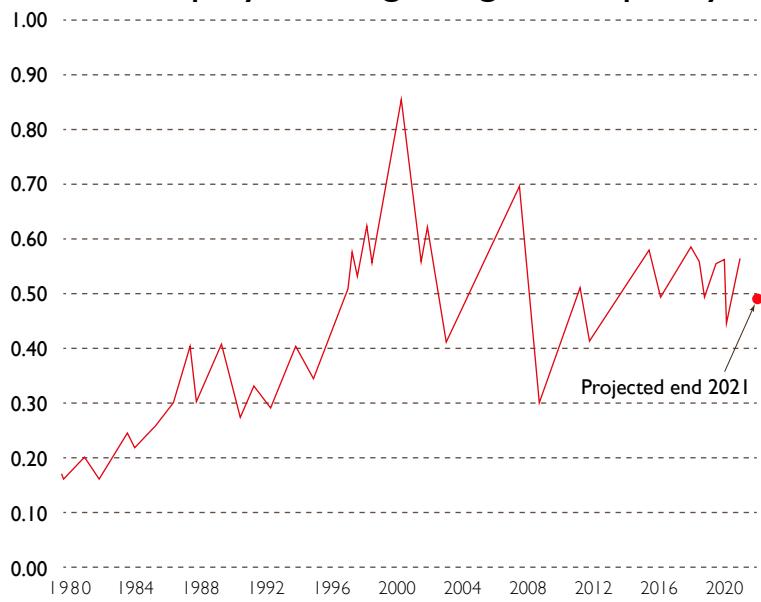
## Global markets are not as bubbly as you think

Another way to understand the importance of these 'top down' asset allocation decisions is to plot the ratio between all investors' equity holdings and the pool of global liquidity. We show this ratio, which averages around 0.5 times over the long-term in the chart above. Although it is currently sitting slightly above this long-term level of 0.5, note that the ratio remains well-below its previous bubble peaks (in 2000 it hit 0.85 times, and in 2008, 0.71). What's more, with the projected rise in global liquidity for this year, the ratio is slated to fall back below this threshold by this coming year-end.

Not only does the liquidity chart tell us that markets collectively are not yet in bubble territory (certainly compared to the most recent historic bubble events), but, assuming that the global economy returns to growth, it suggests that it may be still worthwhile investing in equities, especially if the latest bond market hiatus triggers further near-term pull-backs.

Drilling down into the global liquidity data shows how China and the US dominate. China's nest-egg of liquidity, which is especially important to the Asian region and to emerging markets, now stands at an eye-watering \$45 trillion and exceeds America's pot: only a decade ago it stood at barely \$13 trillion. What's more,

## World equity holdings to global liquidity



much is seemingly lying idle, because Chinese investors have an equity/liquidity ratio of just 0.2 times. The US equivalent now stands at 1.13 times, or nearly one-third above its long-term average. In short, non-US markets look the better deal. The UK stock market stands out as particularly attractive, with an equity-to-liquidity ratio of 0.54 times, and in a mirror-image of Wall Street, almost one-third below its long-term average.

## The money simply has to keep flowing

All feasts eventually end. So, looking further ahead, should more cautious investors be thinking about investing elsewhere? Surely at some stage this liquidity surge must reverse when central banks change course? Not so fast. Although we cannot deny that markets move in cycles, we have to consider just how significantly the world has changed following the build-up of private and public debts in recent times. Worldwide, indebtedness will exceed \$230 trillion this year. This is more than two-and-a-half times global GDP, and has virtually doubled since the 2007-8 global financial crisis.

Worryingly, the enormous scale of these debts may have already enslaved policy-makers, who are understandably now more cautious about raising interest rates. Moreover, because debts have limited terms of as little as one, three or five years, and must be re-financed ("rolled over"), central banks may be forced to leave their money taps running for far longer. In a world dominated by the rollover of these huge outstanding debts, financial markets have become large-scale re-financing mechanisms, rather than simply sources of new money for new capital projects.

These re-financing demands mean that crises could occur when funding stops or even slows. Put another way, "balance sheet capacity" ie liquidity, is now far more important than the level of interest rates, ie the cost of capital. This makes continued central bank QE both vital and probably inevitable – which as inflation is the likely result, may in turn be good news for gold.

**"Central banks may be forced to leave their money taps running for far longer"**

*Investment advisory CrossBorder Capital specialises in the understanding and tracking of money flows around the world. For more see crossbordercapital.com*