

Shifting Liquidity Dynamics a Potential US Equity Headwind

Author



Robert M. Almeida
Portfolio Manager and
Global Investment Strategist

In brief

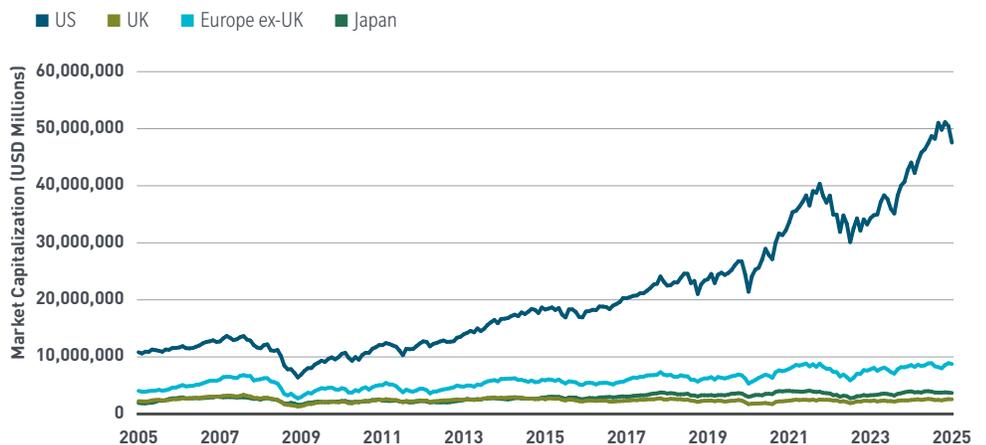
- Shrinking liquidity exacerbates volatility and may help identify which equities are the most vulnerable if liquidity continues to tighten.
- Since the global financial crisis, liquidity largely flowed into financial assets rather than the real economy.
- The post-global financial crisis tailwinds of ample liquidity, globalization and abnormally low interest rates are becoming headwinds at a time when tariffs may drain liquidity.

When volatility hits financial markets like it has in recent weeks, it's often accompanied by a spike in demand for cash and a drain in liquidity. For example, while US equity volumes surpassed all-time highs in April, liquidity shrank, exacerbating price dislocations.

While the excessive gap between volume and liquidity may have been anomalous, it may help investors discern which equities are the most vulnerable if liquidity tightens.

Exhibit 1 illustrates the well-known outperformance of US equities since the global financial crisis. While superior earnings are always the primary performance driver, were there other factors at play?

Exhibit 1: 15 years of US outperformance



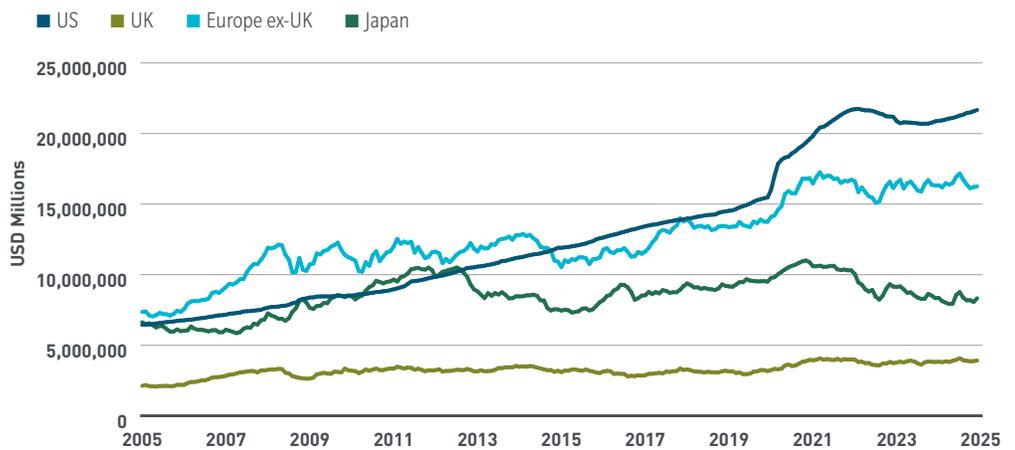
Source: FactSet. Monthly data from 31 March 2005 to 28 February 2025. US = S&P 500, UK = MSCI United Kingdom, Europe ex-UK = MSCI Europe ex-UK, Japan = MSCI Japan. Market Capitalization in USD.

Back in the early-2010s, deflation concerns were front and center. Policymakers, particularly in the US, were desperate to prevent a negative feedback loop of falling prices and money velocity. The solution was liquidity creation, but the problem was how. Liquidity can be created in one of two ways, economic growth or borrowing.



With banks and households in austerity-mode and companies outsourcing tangible fixed investment to Asia, growth wasn't an option. Debt creation through quantitative easing was the path chosen by the United States. The hope was that borrowed funds would drive spending, lift inflation and reignite economic prosperity. Exhibit 2 shows the growth of M2, a broad measure of money supply, for the US and other countries. As you can see, the US wildly outpaced all others. But the growth in money supply failed to produce economic growth because the transfer mechanism of liquidity to the real economy was broken because banks weren't lending, consumers weren't spending and companies weren't investing.

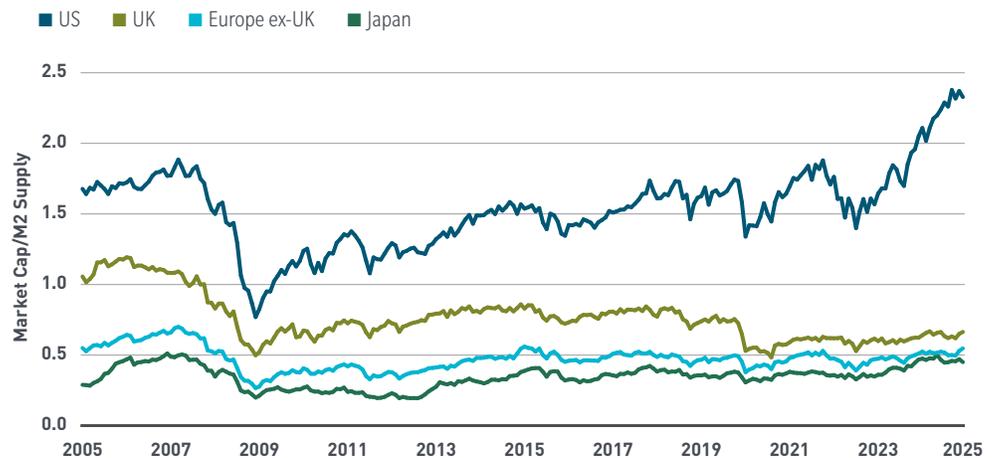
Exhibit 2: Since COVID, a big jump in US M2



Source: Haver Analytics. Monthly data from 31 March 2005 to 28 February 2025. M2 Supply are in USD.

Exhibit 3 is the combination of the earlier graphs, showing market capitalization divided by money supply. Viewed through this lens, the outperformance of US assets is more pronounced, particularly in the wake of COVID-era stimulus. Why might that be?

Exhibit 3: Expanding US money supply found its way into US assets



Source: Market Value from FactSet, M2 Supply from Haver Analytics. Monthly data from 31 March 2005 to 28 February 2025. Market Capitalization represented by: US = S&P 500, UK = MSCI United Kingdom, Europe ex-UK = MSCI Europe ex-UK, Japan = MSCI Japan. Eurozone M2 supply used as proxy for Europe ex-UK. Market Value and M2 Supply are in USD.



US Equities are longer duration

Partially because of the dominance of technology companies, we believe US companies have superior growth rates than the rest of the world. This manifests itself in higher terminal value and lower return of cash flows to investors as cash is reinvested in the business rather than distributed to shareholders. In bond parlance, US equities, particularly US growth and technology companies, are longer in duration than mature, lower-growth enterprises.

This matters in the context of market liquidity. While most market participants think about market liquidity as the ability to trade a security around the price quoted, we can also think about it through the lens of the time value of money. An asset's liquidity beta is a function of market capitalization compared with its duration. Through this lens, the greater the duration, the less liquid or more sensitive the security is to changes in market liquidity. Exhibit 3 illustrates this, as does underperformance of US equities in the past several weeks.

Why might this matter, looking ahead?

Tariffs reduce liquidity

While the situation remains fluid, I think it's fair to assume we'll face more tariffs in the foreseeable future than we did before, regardless of the rate.

Given that the US consumes more than it produces, tariffs are a tax on net importers, meaning companies who import goods to build things, but also households. This tax, no matter the ultimate level, will pull money out of the real economy and threatens what we believe are elevated but unsustainable profit margins.

Conclusion

Shakespeare wrote in *The Tempest*: "What's past is prologue." While perhaps not exactly, the past can help inform us about the future.

The US runs a historic budget deficit, and the massive amount of liquidity created by US policymakers over the past 15 years has had a direct impact on long duration assets.

It's always profits and cash flows that drive stock prices. And for much of this century, US companies have benefited the most from the tailwinds of globalization and artificially low interest rates, which resulted in historic levels of profitability. As I have written about extensively, those tailwinds are becoming headwinds. I believe that if liquidity is drained by tariffs, either slowly or quickly, it may also serve as an additional tailwind for further outperformance for non-US equities and for public assets over private ones. ▲

The views expressed are those of the author(s) and are subject to change at any time. These views are for informational purposes only and should not be relied upon as a recommendation to purchase any security or as a solicitation or investment advice. No forecasts can be guaranteed. Past performance is no guarantee of future results.

GLOBAL DISCLOSURE

Unless otherwise indicated, logos and product and service names are trademarks of MFS® and its affiliates and may be registered in certain countries.

Distributed by: **U.S.** - MFS Investment Management; **Latin America** - MFS International Ltd.

Please note that in Europe and Asia Pacific, this document is intended for distribution to investment professionals and institutional use only. In Canada, this document is intended for distribution to institutional clients only. In Qatar this document is strictly for sophisticated investors and high net worth individuals only.

Note to readers in Canada: Issued in Canada by MFS Investment Management Canada Limited. **Note to UK and Switzerland readers:** Issued in the UK and Switzerland by MFS International (U.K.) Limited ("MIL UK"), a private limited company registered in England and Wales with the company number 03062718, and authorised and regulated in the conduct of investment business by the UK Financial Conduct Authority. MIL UK, an indirect subsidiary of MFS®, has its registered office at One Carter Lane, London, EC4V 5ER. **Note to Europe (ex UK and Switzerland) readers:** Issued in Europe by MFS Investment Management (Lux) S.à r.l. (MFS Lux) – authorized under Luxembourg law as a management company for Funds domiciled in Luxembourg and which both provide products and investment services to institutional investors and is registered office is at S.a r.l. 4 Rue Albert Borschette, Luxembourg L-1246. Tel: 352 2826 12800. This material shall not be circulated or distributed to any person other than to professional investors (as permitted by local regulations) and should not be relied upon or distributed to persons where such reliance or distribution would be contrary to local regulation; **Singapore** - MFS International Singapore Pte. Ltd. (CRN 201228809M); **Australia/New Zealand** - MFS International Australia Pty Ltd ("MFS Australia") (ABN 68 607 579 537) holds an Australian financial services licence number 485343. MFS Australia is regulated by the Australian Securities and Investments Commission.; **Hong Kong** - MFS International (Hong Kong) Limited ("MIL HK"), a private limited company licensed and regulated by the Hong Kong Securities and Futures Commission (the "SFC"). MIL HK is approved to engage in dealing in securities and asset management regulated activities and may provide certain investment services to "professional investors" as defined in the Securities and Futures Ordinance ("SFO"); **For Professional Investors in China** – MFS Financial Management Consulting (Shanghai) Co., Ltd. 2801-12, 28th Floor, 100 Century Avenue, Shanghai World Financial Center, Shanghai Pilot Free Trade Zone, 200120, China, a Chinese limited liability company registered to provide financial management consulting services.; **Japan** - MFS Investment Management K.K., is registered as a Financial Instruments Business Operator, Kanto Local Finance Bureau (FIBO) No.312, a member of the Investment Trust Association, Japan and the Japan Investment Advisers Association. As fees to be borne by investors vary depending upon circumstances such as products, services, investment period and market conditions, the total amount nor the calculation methods cannot be disclosed in advance. All investments involve risks, including market fluctuation and investors may lose the principal amount invested. Investors should obtain and read the prospectus and/or document set forth in Article 37-3 of Financial Instruments and Exchange Act carefully before making the investments; **For readers in Saudi Arabia, Kuwait, Oman, and UAE (excluding the DIFC and ADGM). In Qatar strictly for sophisticated investors and high net worth individuals only. In Bahrain, for sophisticated institutions only: The information contained in this document is intended strictly for professional investors.** The information contained in this document, does not constitute and should not be construed as an offer of, invitation or proposal to make an offer for, recommendation to apply for or an opinion or guidance on a financial product, service and/or strategy. Whilst great care has been taken to ensure that the information contained in this document is accurate, no responsibility can be accepted for any errors, mistakes or omissions or for any action taken in reliance thereon. You may only reproduce, circulate and use this document (or any part of it) with the consent of MFS international U.K. Ltd ("MIL UK"). The information contained in this document is for information purposes only. It is not intended for and should not be distributed to, or relied upon by, members of the public. The information contained in this document, may contain statements that are not purely historical in nature but are "forward-looking statements". These include, amongst other things, projections, forecasts or estimates of income. These forward-looking statements are based upon certain assumptions, some of which are described in other relevant documents or materials. If you do not understand the contents of this document, you should consult an authorised financial adviser. Please note that any materials sent by the issuer (MIL UK) have been sent electronically from offshore. **South Africa** – This document, and the information contained is not intended and does not constitute, a public offer of securities in South Africa and accordingly should not be construed as such. This document is not for general circulation to the public in South Africa. This document has not been approved by the Financial Sector Conduct Authority and neither MFS International (U.K.) Limited nor its funds are registered for public sale in South Africa.