Strategist's Corner
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Shifting Liquidity Dynamics a Potential US Equity Headwind

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In brief

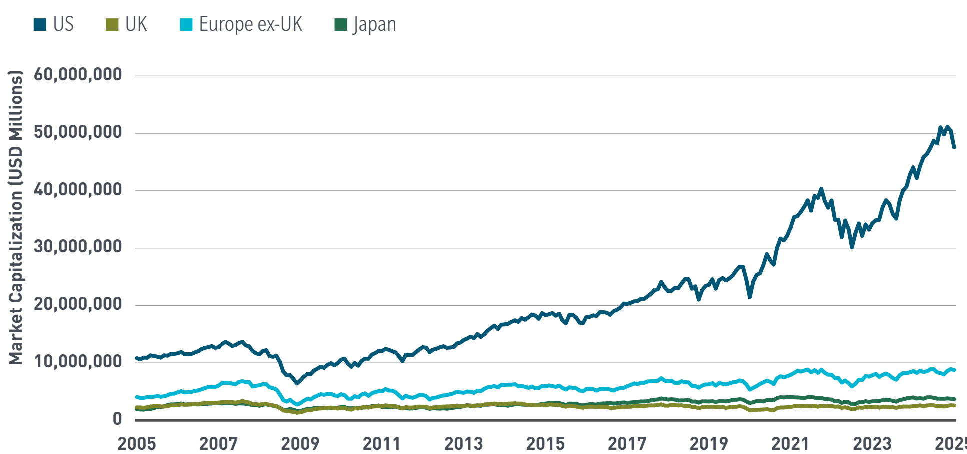
- Shrinking liquidity exacerbates volatility and may help identify which equities are the most vulnerable if liquidity continues to tighten.
- Since the global financial crisis, liquidity largely flowed into financial assets rather than the real economy.
- The post-global financial crisis tailwinds of 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

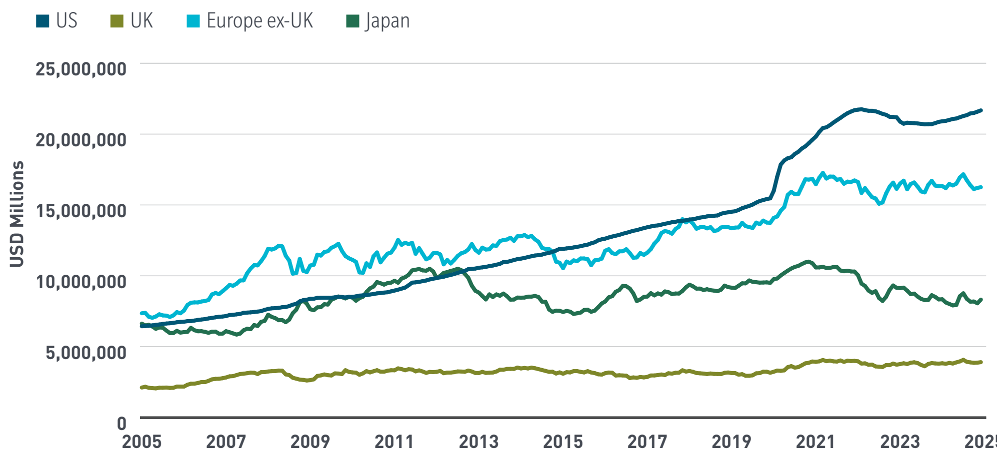


Source: FactSet. Monthly data from 31 March 2005 to 28 February 2025. US = S&P 500, UK = MSCI United Kingdom, Europe ex-UK = MSCI Europe ex-UK, Japan = MSCI Japan. Market Capitalization in USD.

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.

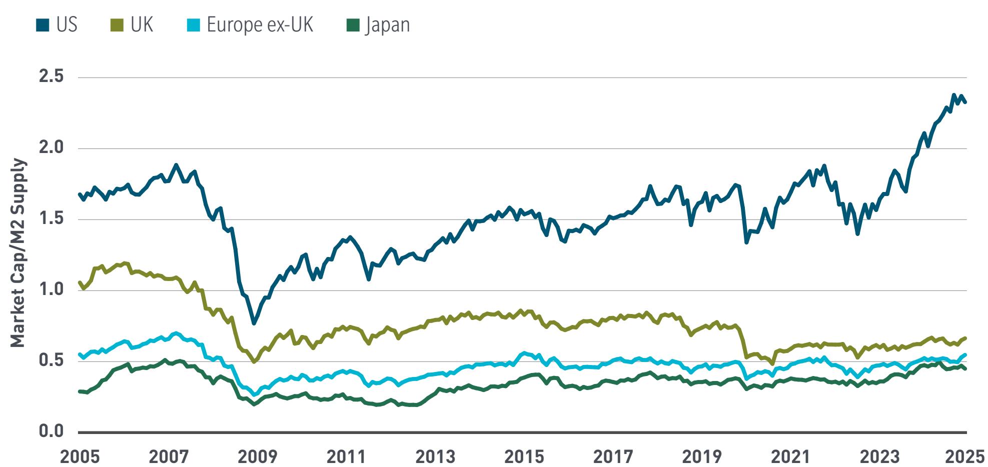
Exhibit 2: Since COVID, a big jump in US M2



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 builds 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.

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