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FCM Weekly Market Notes

Is Liquidity as Good as It Gets?

It's pretty, pretty close to as good as it is going to get in this cycle.

When things are stretched in one direction—whether its equity valuations, asset price movements, or measures of financial liquidity—a simple way to think about it is as a dynamic where things must increasingly go right for that trend to continue. And the number of things that might in isolation currently be low probability events but that would unravel that trend, begin to increase.

Right now, loose financial conditions, which historically have a high correlation with equity prices rising, seem to be at a place where it is as good as it is going to get. That is not to say they cannot continue to be loose for an extended period, but conditions that are even more positive for risk assets are a low probability event.

Take the Chicago Fed's financial conditions index, our favorite indicator. Right now, the index is at its loosest level in over four-and-a-half years, and is roughly around ten year loosest levels except for the brief period of incredibly swift easing post-Covid (lower is looser).

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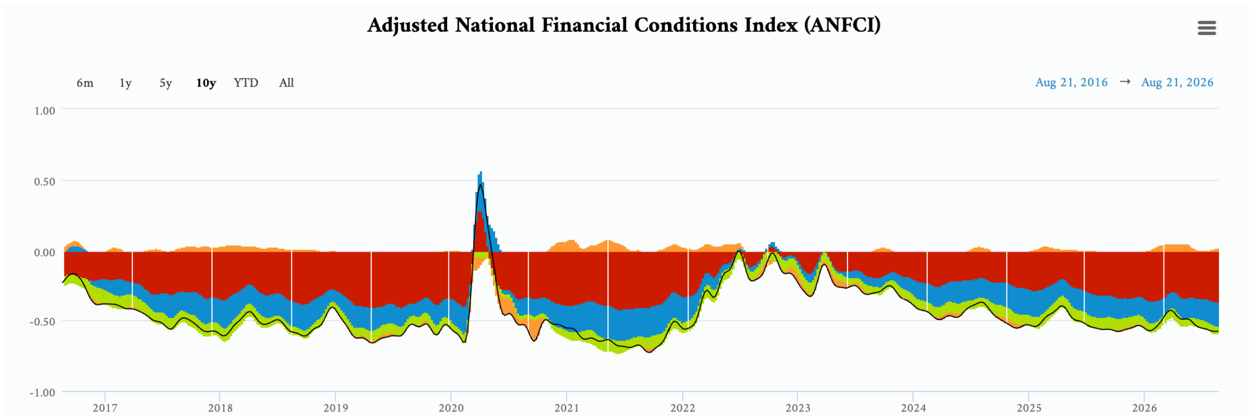
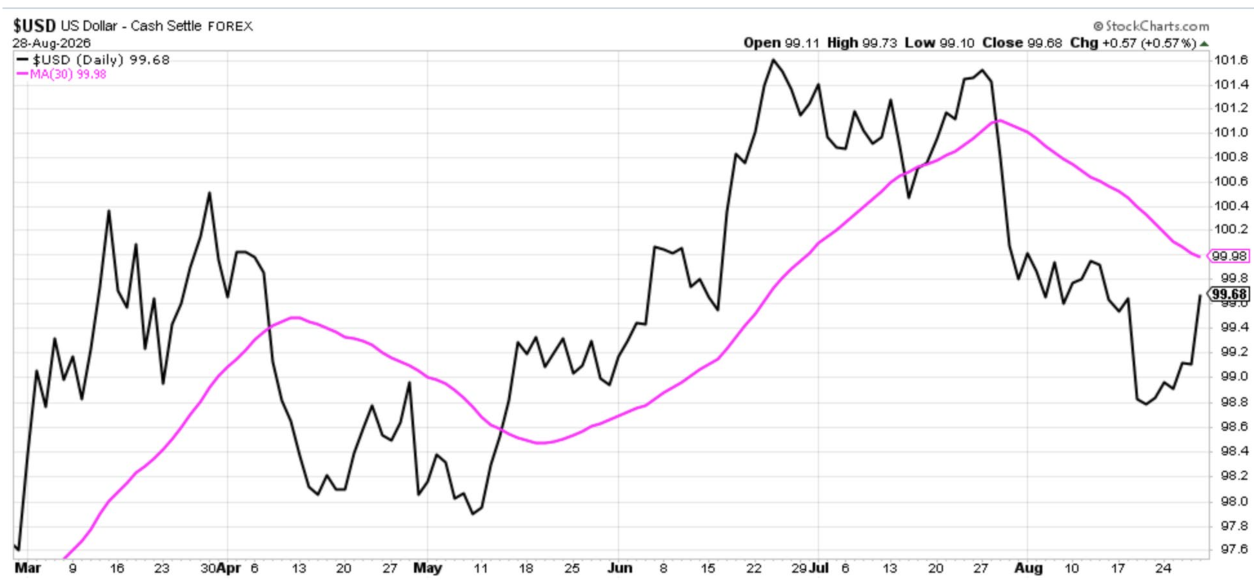


Similarly, high yield bond spreads to treasuries are very close to five-year lows, suggesting risk caution in credit markets is very low.

While many things can go wrong for a trend at stretched valuations, the most proximate cause of this trend reversal is likely to be Fed policy. In his Jackson Hole speech this week, Fed chair Warsh gave what the market took to be a hawkish outlook, with the probability of a rate hike in the September meeting rising from less than even to nearly two-thirds.

The market effect extended to gold, which interrupted what was seemingly the start of a rapid bounce with a more than 3% fall, and the dollar, which rose sharply after his remarks.



Both assets had been trending differently as the market took soft economic growth numbers to indicate that near-term rate hikes were off the table. As much as Warsh has indicated that he doesn't like the Fed providing forward guidance, this sure looked like some clear forward guidance to the markets.

While we will be alert to signs liquidity conditions are shifting, what should you look at in terms of asset prices for a reversal of what has been a fourth consecutive year of robust returns?

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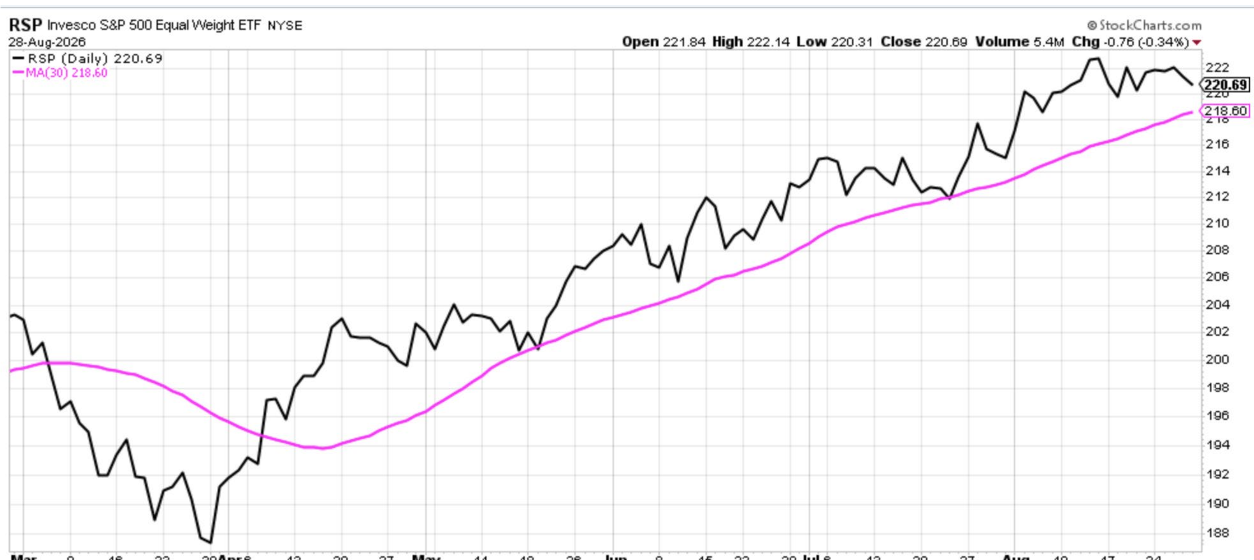
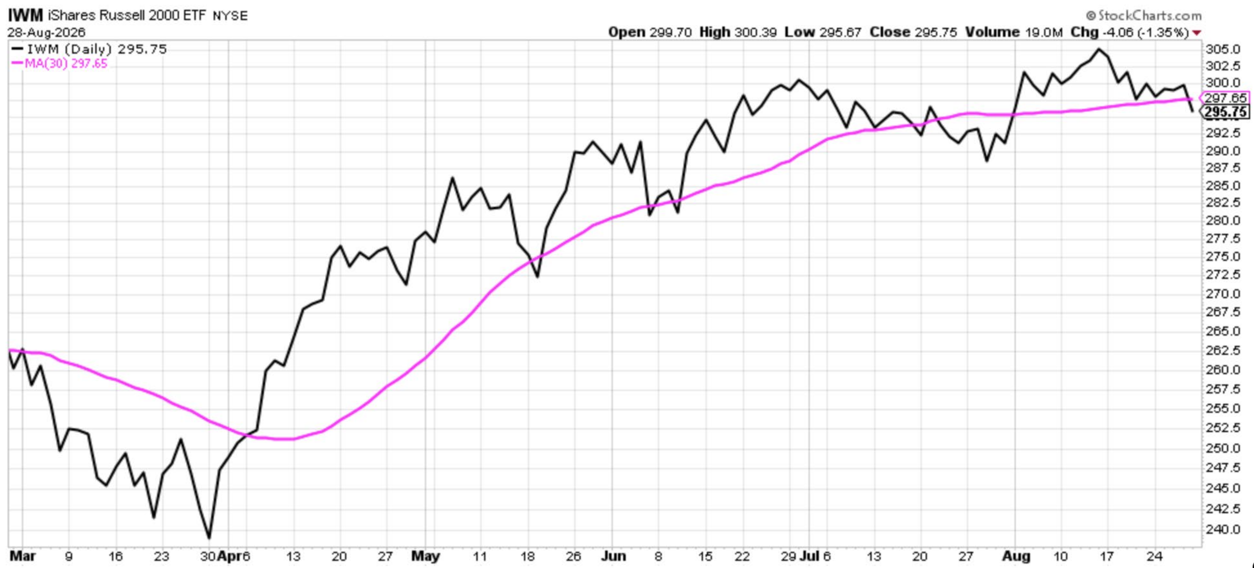
One place NOT to look in our view is at the tech sector or the major indices. Since the beginning of June, the Nasdaq has returned -3.88% while the S&P is up over 1%. Big tech clearly has specific issues related to the viability of the AI-bubble that don't accurately reflect broad equity risk appetite.

Instead, we would look to the price performance of the equally weighted S&P (RSP), and small caps. While the major indices struggle with their huge tech component, RSP has soared over 5% in the same time frame.



Small caps have gained almost 20% for the year. They are an asset class likely to be very sensitive to perceived shifts in liquidity and rates given the higher dependence on borrowing. While small caps barely out-performed the S&P since the beginning of June, we might be seeing the start of some wobbling there:



Small caps have bounced convincingly whenever they have met or slightly fell below their 30-day moving average in previous episodes since April, so that is something to watch closely.

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