



Max Bublitz

Drowning in liquidity

Our fascination with liquidity tells us a lot about the psychology of the financial markets

Liquidity is all the rage these days. Go to any financial media source and there's a good chance you'll find that liquidity is the default explanation for whatever's going on in the capital markets. Why are stocks up so sharply? Why is M&A screaming? Why are rates low? No matter the question, the answer is increasingly 'liquidity'. This one-size-fits-all explanation is starting to resemble some other media-hyped gems, such as Y2K, or how the housing bubble would crush our economy.

This fascination with liquidity begins with the sorry state of the financial media. There's no doubt that journalistic analysis has improved over the last few years. But that hasn't eliminated all of the journalistic offal that gets produced when consumers' short attention spans meet managements' focus on the bottom line. We live in a world where the once sturdy wall between entertainment and news has more holes in it than Bush's plan for the War on Terror.

Tall stories

Nassim Nicholas Taleb's new book, *The Black Swan*, refers to the narrative fallacy where we fool ourselves by creating stories to explain random events. Stories give the illusion of providing reasons why things happen, and the financial media is in the business of packaging those stories. Journalists can get just as caught up in the crowd psychology of the market as today's lenders.

Which leads us to my second thought: perhaps we would be better served by this focus on liquidity if the media were more disciplined about how it was defined. Liquidity can be broken into three broad categories. The first is classic central bank liquidity, where policymakers control the level of bank reserves. The next category of liquidity is the kind that can readily be used to buy something: cash sitting on companies' balance sheets, which can be used to buy their own stock or that of another company; massive, levered pools of capital sitting in hedge fund and private

equity coffers; or capital in the form of petrodollars. The third category refers to the ability to transact in the marketplace without the price being materially impacted or bid/offer spreads going crazy. This, of course, is driven by the market's prevailing mood.

It's tempting to try to measure the amount of liquidity in the first two categories to get an idea about how much fuel is left for the market to burn. It might also appear to make sense to gauge the spread of the current stock/bond arbitrage, so as to find out when it's no longer profitable to lever up once-public companies. But it all means little when the market's mood sours and the third category of liquidity goes bye-bye.

Former Fed chairman William McChesney Martin said: "The job of the Federal Reserve is to take away the punchbowl just as the party starts getting interesting." Back in the day, when commercial banks did most of the lending, the Fed held greater sway. Because so much liquidity (read credit) is now generated outside the banking system – and priced 24/7 – it is becoming increasingly evident that central banks are no longer in total control of the punchbowl. More and more, the credit creation process depends upon the psychological state of those portfolio managers who end up holding financially engineered paper. Admittedly a more diverse crowd, with more cool information and risk management tools than ever before, but a crowd nonetheless.

So what breaks this current fascination with liquidity and disperses the crowd from one side of the ship? Any one of the three categories of liquidity can and will go away at some point, most likely in combination. The best answer, however, is probably the response given by former British prime minister Harold Macmillan when asked what might steer a government off course: "Events, dear boy. Events."

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