The 'Liquidity' Rule Boosts EM Equities

By Michael du Jeu

mdujeu@gavekal.com

The Gavekal TrackMacro model combines seven fundamental macroeconomic rules to provide equity risk-on or risk-off signals in 40 countries. One of these, the USD liquidity rule, measures the growth of USD availability in the world in real terms. It turned positive at the end of March 2020, for the first time since December 2017. The dollar shortage is over.

We all know the reasons for this: unprecedented increases in fiscal expansion and money creation following economic lockdowns, and widespread GDP destruction unseen in peace time. The USD liquidity rule was immediately impacted by such extreme changes.

A New Record in USD Availability

The liquidity rule tracks changes in two metrics: the level of USD currency in circulation in the USA, and the level of USD deposited at the Fed by foreign central banks. The rule does not track monetary mass but central banks' money, out of which pyramids of credit can be built. In other words, it tracks the foundations of global liquidity.

On the one hand, the US Federal Reserve decided to monetize the massive economic consequences of lockdowns, as evidenced by the USD 1.6 tr increase of its balance sheet (red line on Fig 1). On the other hand, the fall in worldwide economic activity and oil prices did not trigger major USD withdrawals from foreign central banks deposits with the Fed (blue line Fig 1).

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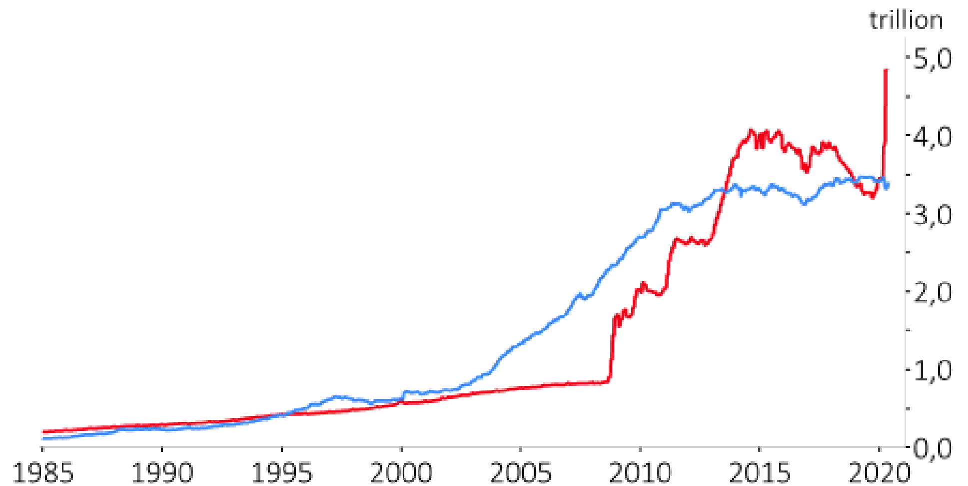
Fig 1. Federal Reserve Currency in Circulation (red) and Foreign Central Banks Deposits (blue)



Source: Macrobond

As a result, the world now faces a Fed balance sheet unprecedented in size, and foreign central banks' reserves also near their highest level. In plain macro terms, there is liquidity aplenty to boost a domestic economic recovery, and to support international access to USD to expand growth and trade.

Historically, such a positive reading of the liquidity rule has been incredibly supportive of emerging market equities for the following reasons. Excess USD liquidity can fuel four types of inflation: on goods, on assets, on growth, or on currencies ex-USD. The four types of inflation are favorable to commodity exporters, and to emerging markets in general, especially those funding a part of their expansion is USD. We show this below.

Liquidity Boosts EM Equities

In the last 30 years, EM equities returned Libor USD +21.1% in high liquidity environments and Libor USD –5.9% in low liquidity times.

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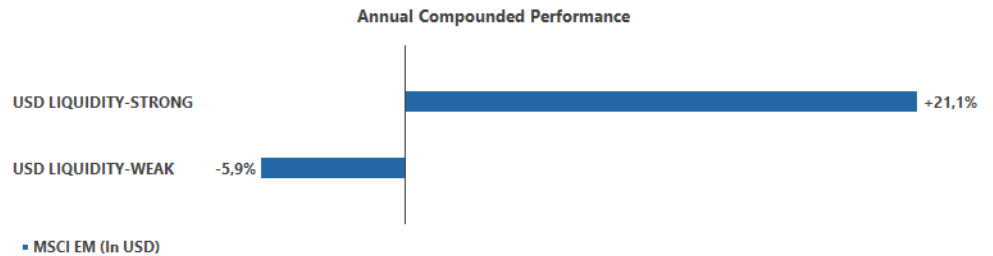
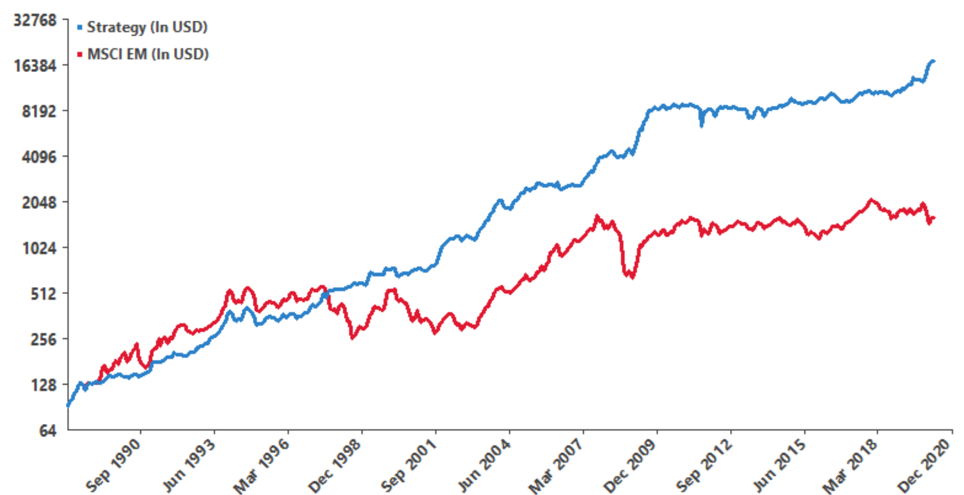
Fig 2. The liquidity rule clusters EM equity returns depending on its state (strong or weak).



Source: TrackRisk by Gavekal Intelligence Software

A simple strategy is therefore to invest in EM equities in high liquidity times and safely turn to US Long Bond otherwise. The Gavekal TrackRisk software can help simulate such as strategy. Since 1987, it returned 17,5% per annum as compared to 9,3% for the MSCI EM and 8,7% for the Long Bond.

Fig 3. MSCI EM when USD Liquidity rule is positive and Long Bond otherwise (Blue) vs. MSCI EM all time (Red)



Source: TrackRisk by Gavekal Intelligence Software

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The strategy has outperformed the MSCI EM at all timescales before and after the model went live (June 2015).

Fig 5. Strategy returns and risks against the MSCI EM

Period	Asset	Return p.a.	Volatility p.a.	Drawdown
Since Dec 1987	Strategy	**17,5%**	15,2%	-26,1%
	MSCI EM	**9,3%**	22,4%	-61,4%
Past 20 Years	Strategy	**17,7%**	15,7%	-26,1%
	MSCI EM	**6,7%**	21,6%	-61,4%
Past 10 Years	Strategy	**8,0%**	13,5%	-26,1%
	MSCI EM	**2,8%**	17,7%	-29,5%
Past 5 Years	Strategy	**13,5%**	11,7%	-13,9%
	MSCI EM	**1,2%**	17,5%	-28,3%
Past 3 Years	Strategy	**20,2%**	12,6%	-8,7%
	MSCI EM	**0,1%**	17,8%	-28,3%
Past 1 Year	Strategy	**39,5%**	15,5%	-6,5%
	MSCI EM	**-4,3%**	22,6%	-23,6%

Source: TrackRisk by Gavekal Intelligence Software

Finally, the strategy boosted returns whilst lowering drawdown risk from -61,4% to -26,1%. Risk and return can act in opposite directions in dynamic portfolio construction.

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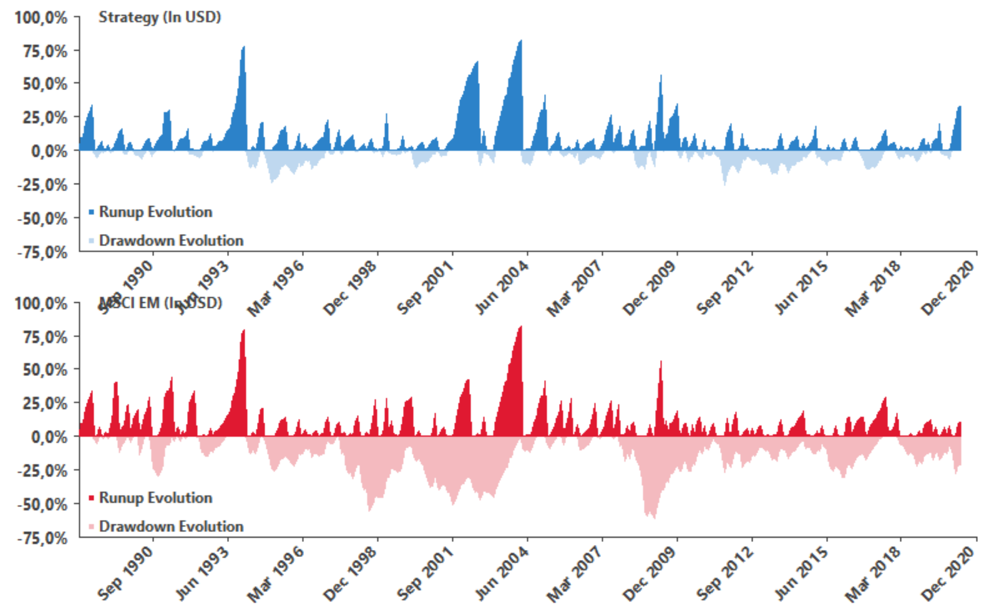
Fig 3. Drawdowns and Draw-ups: Strategy (in blue) vs MSCI EM (in red)



Source: TrackRisk by Gavekal Intelligence Software

Conclusion

Liquidity is certainly not the sole macro factor driving equity returns. However, it weighs heavily on the relative performance of emerging market risk assets. The lesson from the flashing of this metric is clear: it is time to overweight emerging markets.

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