Perpetual Equity Investment Company Limited (ASX:PIC)

Liquidity, correlations and central banks yet to be tested

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One thing investors will need to grapple with the next time the market rhymes is liquidity. Liquidity is like oxygen. Investors take it for granted that it will always be there, but when it isn't those that don't have it find out quickly.

One reason there has been little focus on this issue is that central banks have appeared to provide so much of it. But for how long, especially as they have sought to reverse it? Vitally, central banks have delivered great liquidity over the last decade but at the expense of volatility.

On the surface this central bank suppression of volatility seems good but is it seemingly setting the market up for more aggressive volatility events down the track? This is especially relevant because so many of the traditional sources of liquidity that would otherwise step in have dried up.

With regulations post the GFC, like the Volcker Rule, shutting down so many market participants (especially the proprietary trading desks at the banks) much of the traditional source of liquidity has disappeared.

Brokers, dealers or market makers used to step in and provide liquidity when others were selling. But if current buyers all decide to sell, who will fill the gap to stop prices declining sharply? Quantitative funds have shown a tendency to step back when prices drop. Instead of eliminating volatility central banks might have just saved it up for larger and more disruptive sell-offs. This is one of the many conundrums to be resolved by the current market.

Lastly, correlations between asset classes are high; not just equities but cars to coins to art and gems, everything has had a major price run. Normally there would be some place to hide. But not even bonds offer the usual protection as the markets and central banks drive bonds into negative yield territory. Even some high yield debt, formerly known as junk bonds, are trading on negative yields.

Central banks are entering a dangerous new phase. Binyamin Applebaum recently wrote in his latest book that JFK's Treasury Secretary Doug Dillon refused to let academic economists get too involved in treasury matters and William McChesney Martin (the Fed Chair at the time), also refused to let them get too involved, both considering them too academic for pragmatic decision making. Recently though, theory has dominated monetary decision making, some considering the whole of the last decade a giant monetary experiment. Whilst Trump did not renew Dr Yellen's contract, he replaced her with Jerome Powell, who is a lawyer by training but has a long history in investment banking and marks a clear departure from academia. Meanwhile, the European Central Bank has ditched a long line of professional economists in favour of a politician. Whether these are the right moves only time will tell but it may be that some of the academic experiments of recent years may be ending and the time of policy pragmatism may be coming back.

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