A Persistent Bid

Let's talk about asset shortages.

If you're active on fintwit then you've probably heard people mention the possibility of a coming asset shortage squeeze — I myself, have been mulling the idea over.

But the concept is a fuzzy one. There's little research on the topic. Very few people are aware of the idea and its impact. And even those that do talk about it, have serious misconceptions of how it actually works.

Even more importantly, it's a useful model to apply in our framework for analyzing market cycles — it's at the heart of what drives bull markets (hint… it's not earnings). It also ties into our debt cycle model and is likely to become an important driver of market returns over the coming year. So knowing what it is and how it works will put us ahead of the market… which is where we want to be.

Everything in markets comes down to supply and demand. Our jobs as speculators is to figure out the two and see if there's a mismatch that will lead to a price change (a trend). So let's start by defining market demand.

Investors can allocate their savings to three main assets: stocks, bonds, and cash. They make these allocation decisions based on desired returns and tolerance for risk to come up with a portfolio mix — the classic being 60% in stocks and 40% in bonds/cash. **Recent price appreciation (not valuation or yield) is the overwhelming driver behind this allocation decision.** Momentum is the bottom line, which means investors are always chasing the trend — nobody likes sitting out of a rising market.

Savings — the amount of money available to invest — fluctuates according to the levels of cash + credit (money) in the system. Since credit is easier to create than cash (any two willing parties can create credit out of thin air with an IOU), **credit largely drives the amount of investable money in the system**. Rising lending equals more savings to invest. The amount cycles up and down in accordance with our debt cycle framework.

The supply side of financial assets is comprised not just of the total amount of shares or bonds in existence, which is what many people mistakenly think. Rather, **it's the market value — the total dollar amount in existence at current market prices — that makes up supply.**

This means that the equity market has a flexible supply. **If the demand for stocks increases then those flows will drive up prices along with the overall market value thus creating more supply to meet that demand.** It's a system that automatically self corrects over time.

The bond market on the other hand, has a theoretical supply limit.

There's a ceiling on the market value of bonds because credit shouldn't trade much above the price which corresponds to a 0% yield to maturity. It used to be thought that this was an iron clad rule. But after years of NIRP we now know that bonds can and do trade above this limit, in which their yield is negative. But even here, they can only trade so far above this level that there's a range that serves as a limit on bond market value and hence supply.

So to summarize, the basics of our supply and demand model is:

- On the demand side we have:
    a. The amount of savings available to invest is largely driven by the credit cycle
    b. The allocation mix of investor portfolios is largely driven by performance chasing
- On the supply side we have:
    a. Supply is made up of the total market value of the asset and this market value is equal to the amount of shares + the price at which they trade
    b. Stocks have a flexible supply in that greater demand leads to higher market value and more supply
    c. Bonds have a theoretical limit in that they can't trade much below 0% interest rates

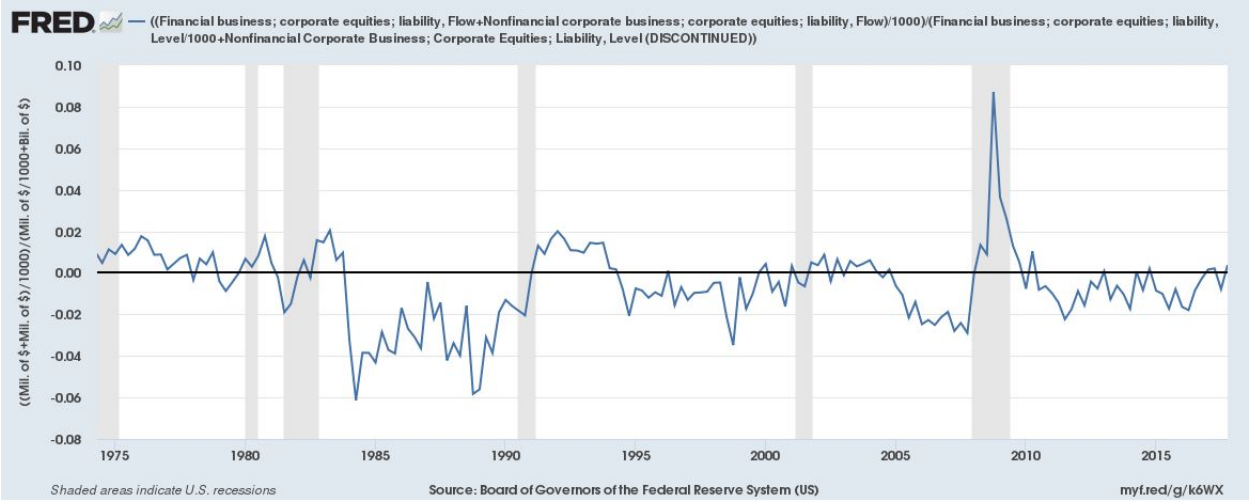
This is a very different of thinking about what moves the market. It's the model that Stanley Druckenmiller was referring to when he said:

> ***Earnings don't move the overall market; it's the Federal Reserve Board… focus on the central banks and focus on the movement of liquidity… most people in the market are looking for earnings and conventional measures. It's liquidity that moves markets.***

Liquidity ***is*** credit driven investment demand. This isn't to say that earnings don't matter. They do, especially on an individual company level. But on the aggregate, **earnings are largely a result, not the cause of, the liquidity driven short-term debt cycle.**

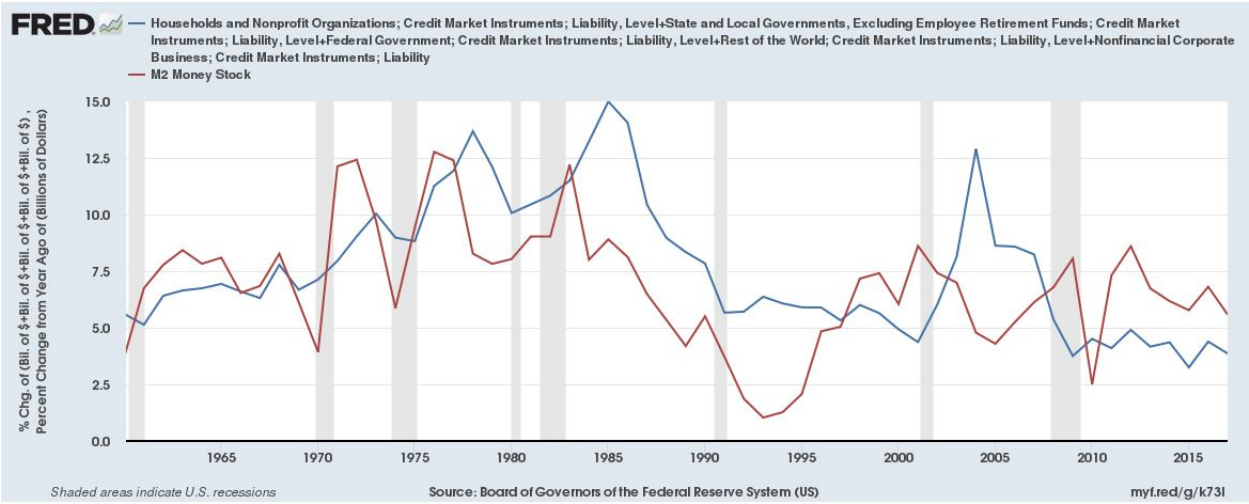
We can look back through time and see how this model correlates to market returns.

Historically, US corporate share issuance has rarely exceeded 2% and over the last three and a half decades **corporates have been actively reducing their share count through buybacks and M&A at an average annual rate of 2%**. Chart below shows net corporate share issuance.



While the amount of shares has been falling, the amount of money (cash+credit), has been steadily increasing.

Over the last 50 years, t**he US's money stock has been rising at an average annual rate of 8% a year.** Chart below shows total new credit (blue line) and M2 cash stock (red line).



So over the last five decades we've had the supply of equity shares shrinking by an average of 1-2% a year, through buybacks and M&A. And we've had the total money stock increasing at an average rate of 8% a year. Disregarding total market value and investor allocation preferences for a second, this gives us a supply/demand mismatch of roughly 9.5% a year.

Well, guess what the average annual return has been on the stock market over the same period?

That's right...9.5%.

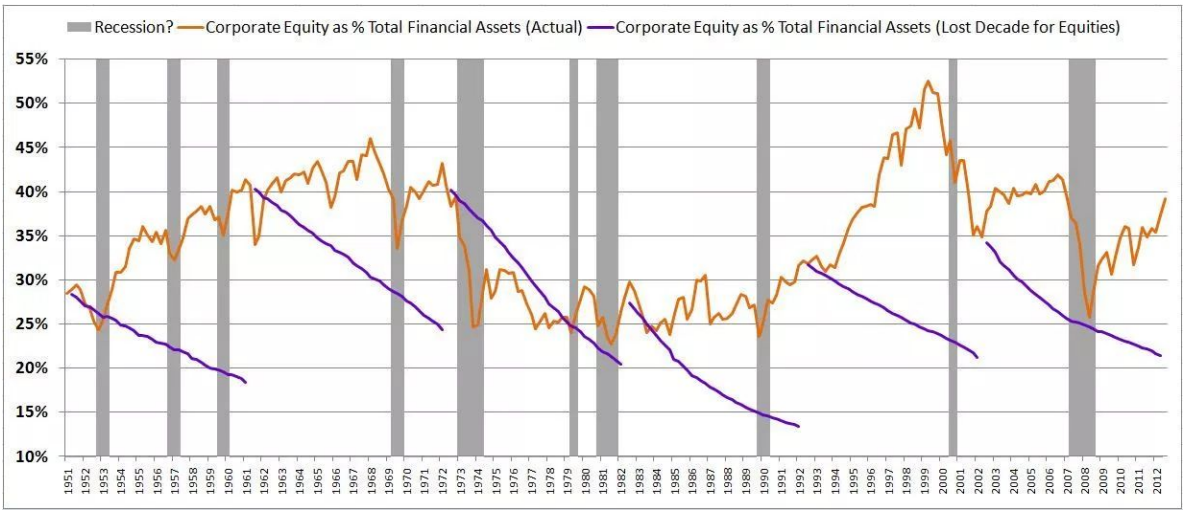
The stock market's average annual returns equal the supply/demand mismatch of share reduction and money creation over the same period. This isn't coincidence. It's just math.

You see, if investors keep their portfolio mix (their allocation preference between stocks, bonds, and cash) relatively constant, then **the market value of stocks has to rise at the same level of the supply and demand imbalance between share reduction and money creation**.

If not, investor's allocation to equities will dwindle relative to bonds and cash and the market value of stocks will fall on a relative basis to the amount of investable savings.

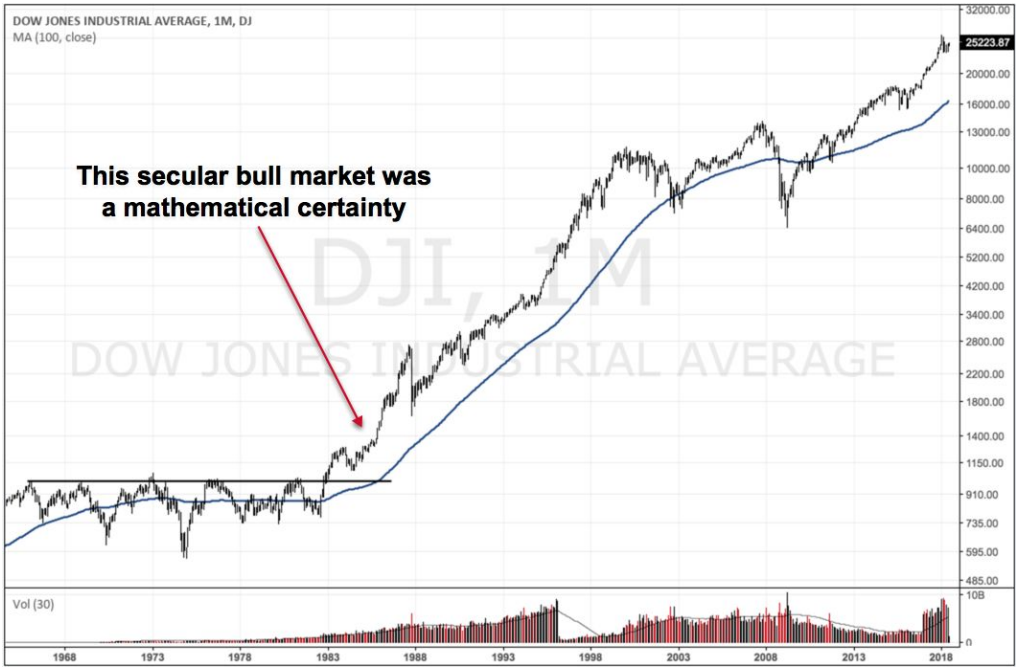
We can see what this would look like on the chart below via ***Philosophical Economics***. The chart shows how much the investor allocation to stocks would decrease by if the market went through a "lost decade" period; where the share count / money demand imbalance grew at its historical rate, but stock prices stayed constant.

The purple line shows the allocation to equities over each hypothetical "lost decade" period and the orange line shows what the actual allocation to stocks was.

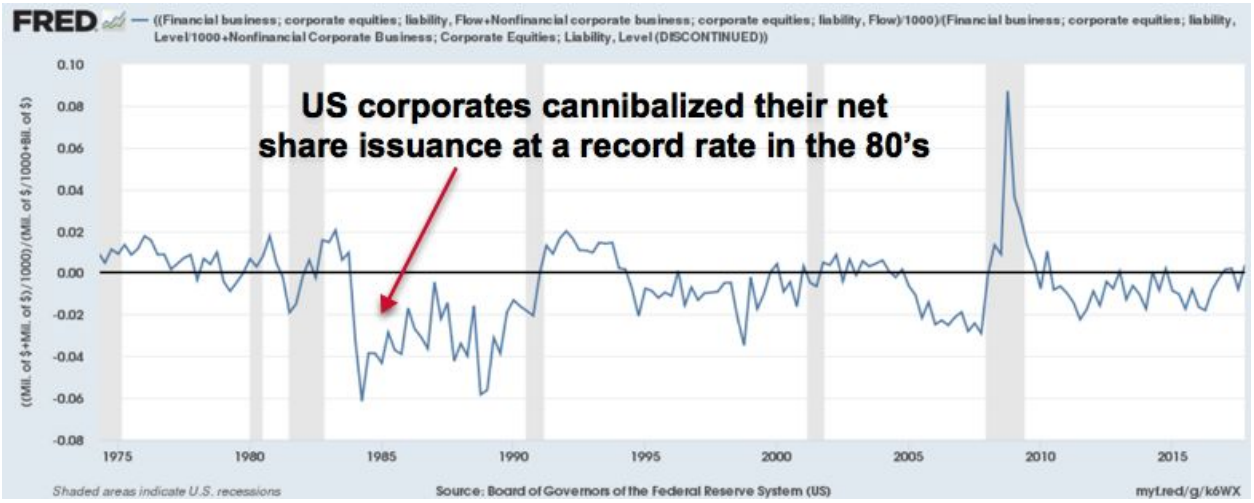


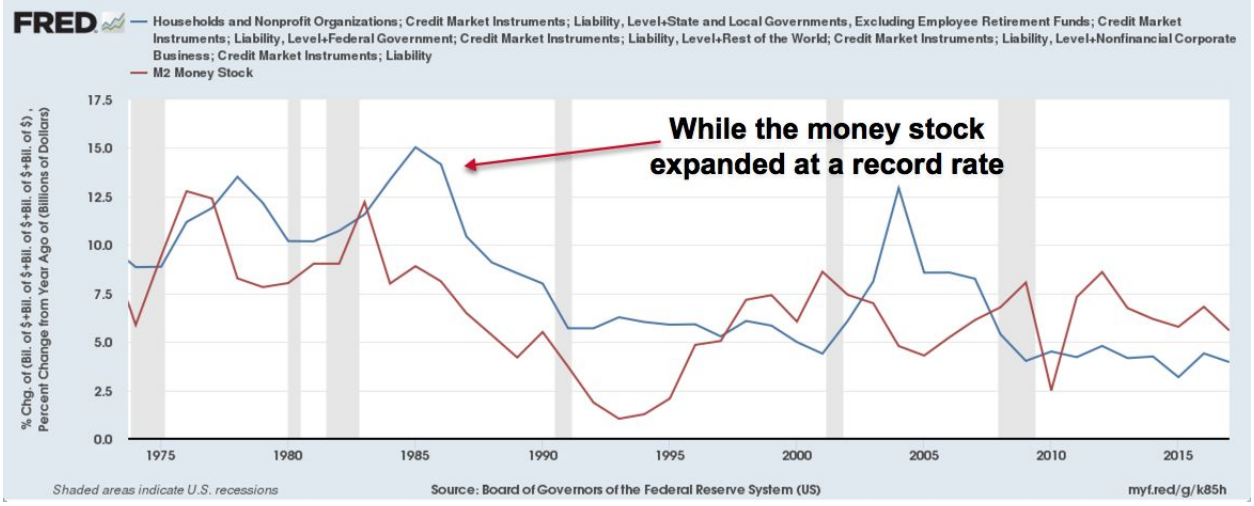
So we can see, **the market has to rise over time because we operate in an inflationary market system, where the quantity of money is nearly always growing and the corporate sector's aversion to dilution keeps share growth at a minimum to net negative.** The only way for the market to clear — for supply and demand to balance — is for the market's total value to rise, increasing the supply to meet the demand.

If you were trading back in the early 80s and you understood this market supply and demand model, you would have foreseen the massive secular bull market that was ***mathematically inevitable.***



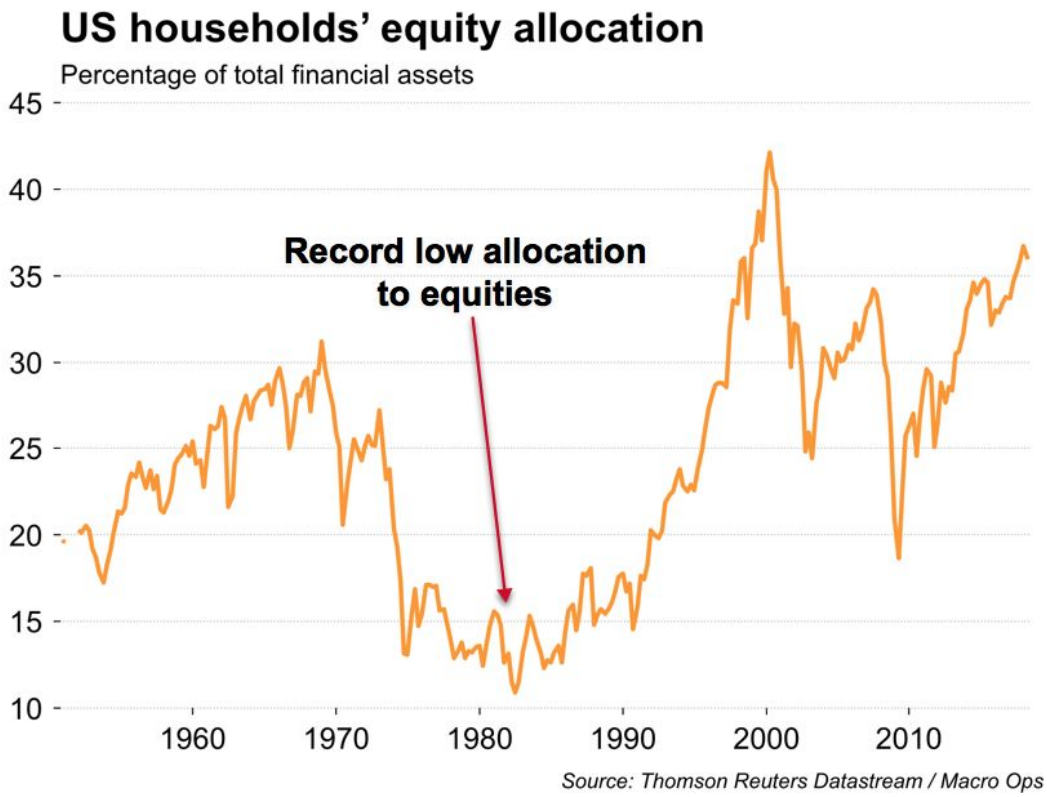
In the early 80's we saw a perfect storm that led to a huge imbalance between the supply of equities (shares issued plus total relative market value) and demand (total money creation plus investor allocation).





We can see that following the 1981 recession both money creation ballooned to all-time highs and corporates saw record net negative share issuance.

At the same time, investor's allocation to stocks hit an all-time low of 12%! Chart below shows household's allocation to equities as a percentage of total financial assets.



At that rate of money creation and net share decline, investor's allocation to stocks would have had to fall to ***near zero*** just to keep the market from rising.

The secular bull market HAD to happen so that the market's total value could rise, bringing supply up to meet demand and allowing the market to clear.

Now let's apply this model to markets today.

Currently, investor's allocation to equities is nearing secular highs; roughly double what it was in the early 80's but still below the levels reached in 2000. Money growth is positive but slightly below average. And net share issuance is average, at a roughly 1.5% annual deficit throughout this cycle.

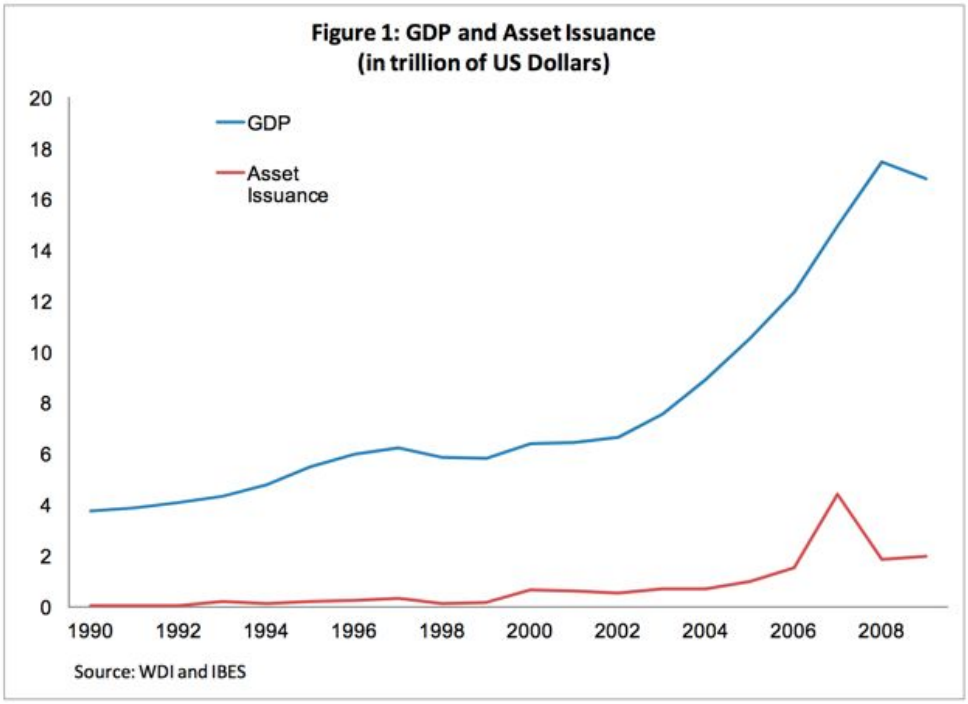
From this we can see that the bull market has been driven by dwindling share supply + positive money creation + a shifting investor preference to hold more stocks as a percentage of their portfolio.

But there's another factor that we need to introduce and which has become more important over the last 20 years with the rise of globalization. And that's the growing money stock in emerging markets. It's here where things get interesting.

Classical economic theory states that capital should flow from rich countries to poor countries. But, like much of economic theory, this isn't how the things ***actually*** work.

The IMF points to the reason why in a recent paper, saying an "economy's ability to produce output is only imperfectly linked to its ability to generate financial assets."

The chart below shows this. **As emerging markets increase in size, their domestic financial markets lag behind — their financial assets grow at roughly half the rate of GDP. With a limited domestic pool of securities, EM savers end up having to invest the majority of their wealth abroad.**



The IMF hits at what this means for developed market asset demand, writing “improved macroeconomic fundamentals have raised the demand for financial assets. Rising income per capita in EMs, pension reforms in Latin America, increasing commodity prices in the Middle East and Africa, and limited consumption growth in East Asia have contributed to an increasing supply of domestic savings in EMs that needs to be invested.”

As emerging markets mature, their ability to generate credit and grow their money stock rises exponentially. And since EM financial markets can’t soak up this ballooning money stock, it means that an increasing amount of it ***has*** to flow into the US; which has the deepest financial markets in the world. This significantly raises the demand for US assets.

This is why this bull market continues to trudge on, irritating perma-bears who think it has to end for the sole reason of that it’s gone on so long.

But as long as emerging markets stay buoyant, propped up by a slowing but still growing China, and commodity prices (particularly oil) stay elevated — keeping petrodollars flowing back into US financial markets — then the global money stock will continue to expand. And that means a persistent bid for US assets which will lead to a higher market value so supply and demand can eventually clear.

When we combine this structural bid for US risk assets with the increasing likelihood of a late cycle FOMO chasing leveraging phase — a phase which tends to mark the end of most long bull markets. We end up with a high likelihood of seeing an asset shortage induced squeeze. A

boom in stock market value that will create greater supply. A supply that will eventually peak once global demand begins to contract. And then the process will work in reverse as a major supply glut will have to clear...

Should be a fun road ahead.

Macro: K.I.S.S.

In the Marine Corps we operated by the acronym K.I.S.S. which stands for Keep It Simple, Stupid. The idea is that systems and operations work best if they're kept simple and not made more complicated than need be. Combat is plenty confusing on its own and it's easy to suffer from information overload which can lead to failure to follow through or total analysis paralysis. Both of which could get you killed.

Thankfully in markets we don't have to worry about catching lead. But it pays just as well to heed the principle of K.I.S.S when playing the macro game. There's an endless deluge of data, opinions, and explanations for market moves. Macro is complicated enough. Our job is to distill and simplify and apply Occam's Razor and track the few things that matter most at any one time until new information disproves their utility.

We believe the most important drivers right now are:

1. A decelerating China that's trying to set itself up for a strong centenary in 2021
2. Slowing global growth relative to the US which is drawing capital from the periphery back to the core (US), leading to a stronger dollar -> tighter liquidity -> greater volatility -> stronger dollar feedback loop
3. The turning of the long-term debt cycle which is driving divisive populist politics and greater geopolitical tension

The craziness going on in Turkey, Argentina, Italy, and Brazil is important too, of course. They're interesting stories to follow and we can find some unique trades to play those specific developments. But in the broader macro sense they are symptoms of the above three drivers and not underlying causes themselves.

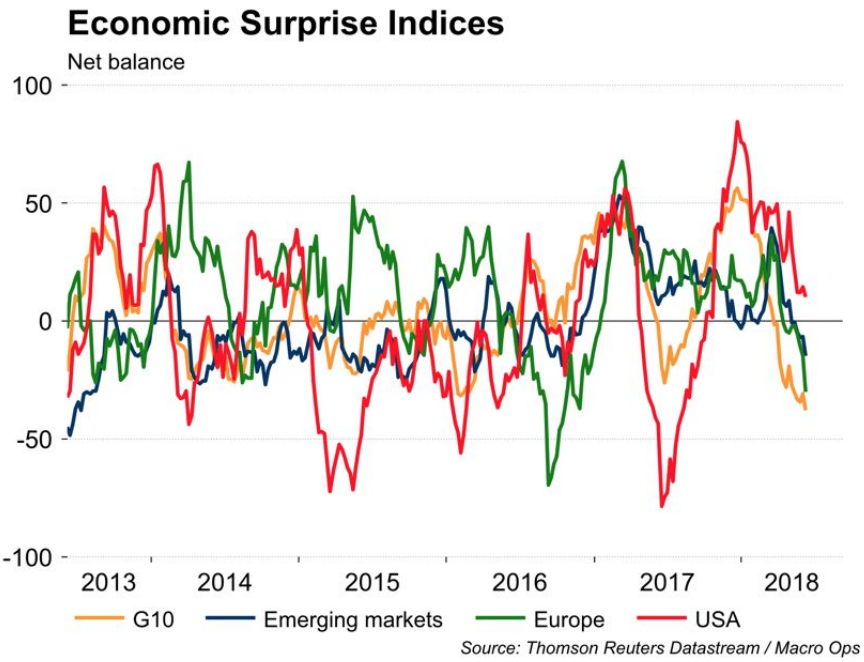
Let's go through some charts and see what the data is telling us about our three drivers and discuss some related trades/themes. We won't cover China since we discussed it last month and there's nothing to update.

Flowing Back To The Core

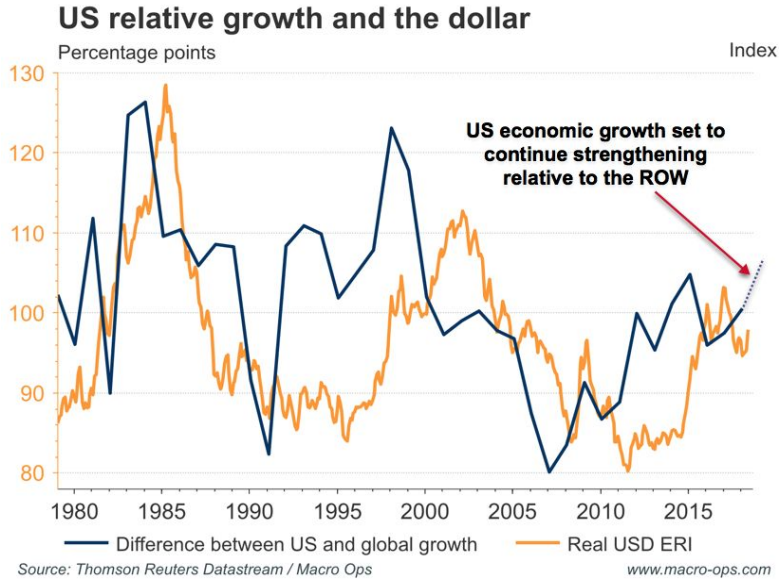
The data and the tape continue to confirm our US vs. rest-of-world (ROW) outperformance thesis. This opinion rests on a continued growing disparity between US economic and market strength relative to the ROW.

The chart below shows earnings momentum across world. This is a leading indicator that measures analyst earnings revisions (changing expectations). It shows that earnings expectations are in decline everywhere except for the US, where they remain extremely robust.

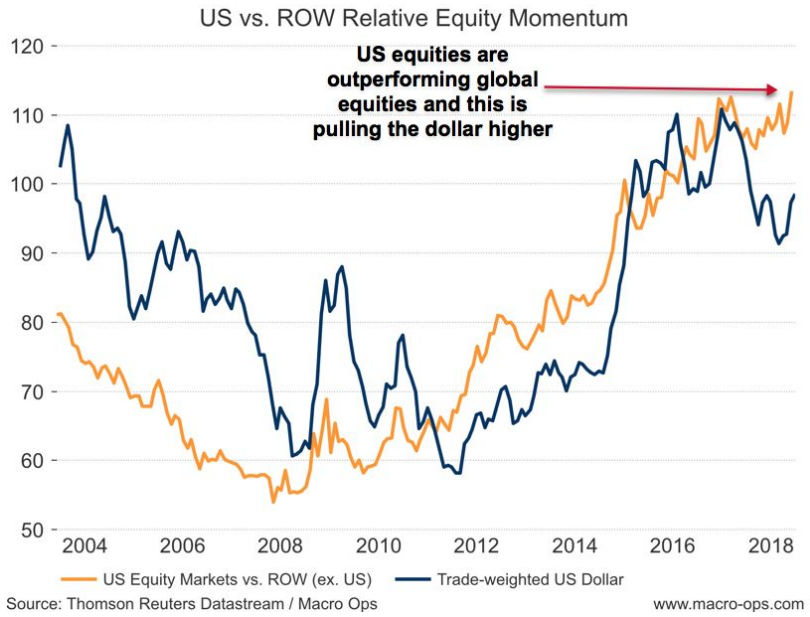
The Citi Economic Surprise Index (CESI) which measures economic data prints relative to expectations (data surprises) show that data has been coming in below expectations everywhere except for the US (below 0 is a negative surprise and above 0 is a positive surprise).



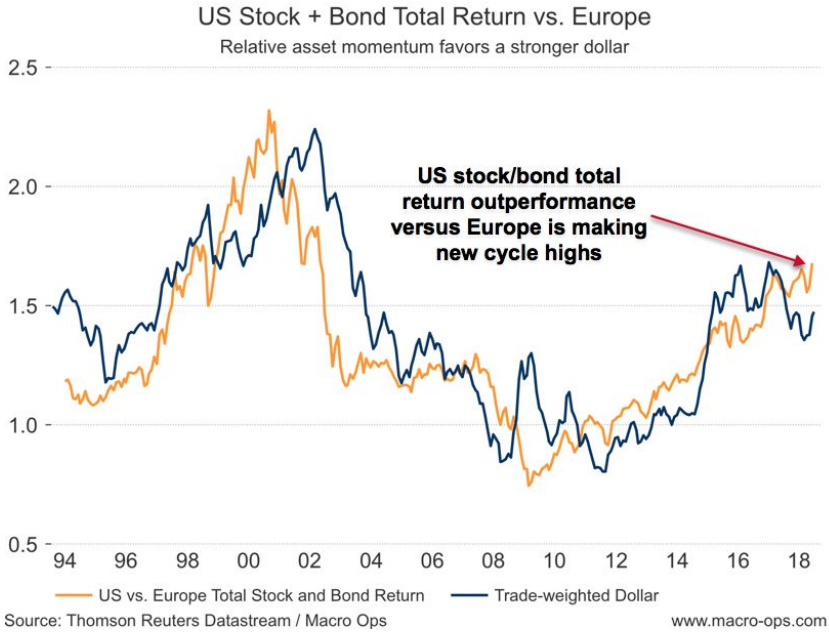
And we can see the US outperformance directly in the economic growth numbers where relative GDP US trend growth is accelerating versus the ROW. This indicator has a high correlation to future US dollar performance.



Slowing global growth combined with a strong US economy is pulling capital back from the periphery and into the core. This is driving relative US equity outperformance which is leading to more speculative inflows driving US stocks and the dollar higher.



When analyzing the dollar we have to pay special attention to the euro since it makes up a majority of the dollar trade weighted basket. This chart shows US vs. Europe stock+bond total relative returns. US stock/bond relative performance recently made new cycle highs. This is pulling the dollar higher and driving a self-reinforcing feedback loop.



Looking at the treasury data we can see these capital flows directly. The blue line on the chart rises when US investors sell their foreign assets. We can see there's a circular relationship between the two.