Competing for Liquidity:
Financial Markets vs. the Treasury Department

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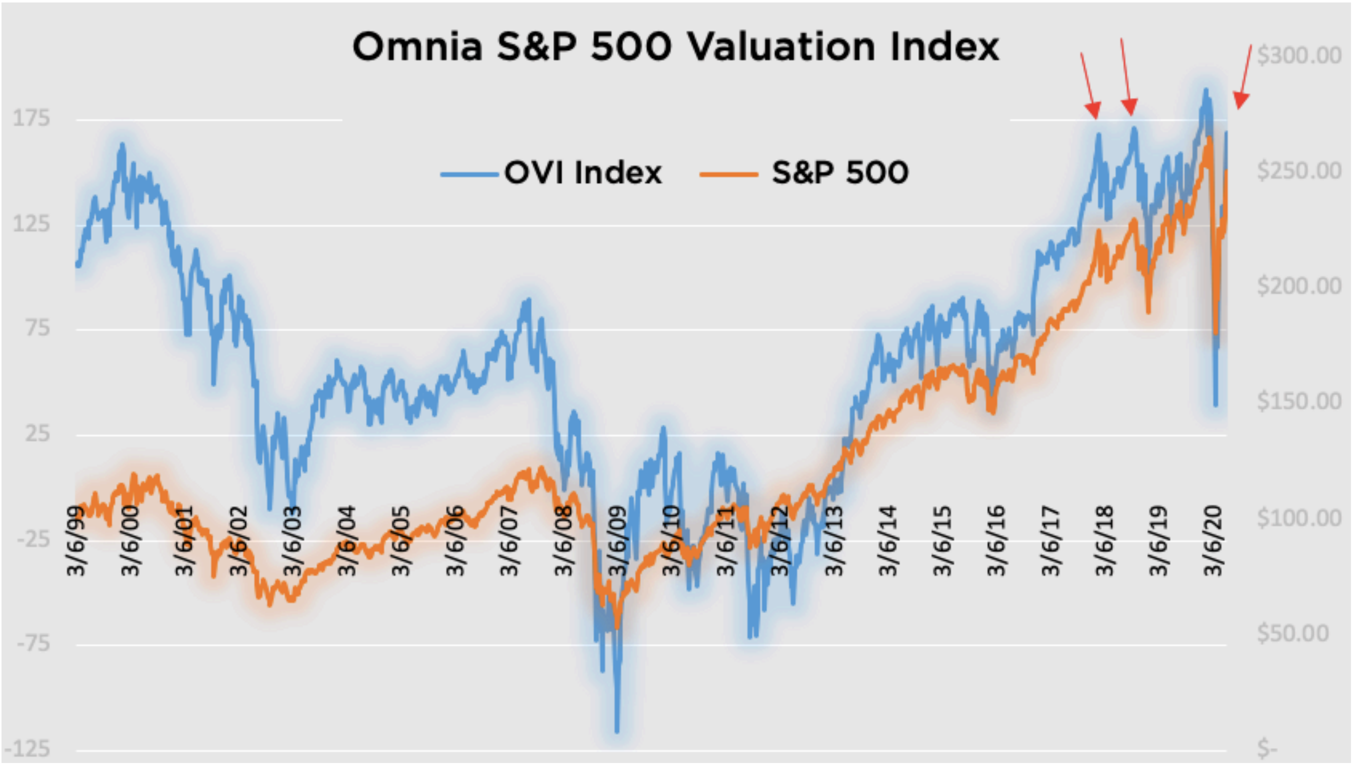
The US equity markets are roaring higher, against most, if not all, analysts' and economists' projections. Yes, we agree that there is a disconnect between the fundamentals and valuations, or between the real economy and financial markets. Below is our valuation model you have seen many times.

Valuation levels as of June 8, 2020, are at the levels they were before two large market corrections in January 2018, and September 2018. In January 2020, these levels broke higher with the help of the Fed but didn't get too far before falling again. The model is not a crystal ball, but it tells us that investors are paying very high prices for the earnings companies are providing… high risk with zero expected returns. But we have to remember, the market doesn't really care what we, or other people, think about valuations. **That's why we do not attempt to time the markets.**



Source: Omnia Family Wealth

If you ask investors, professionals or not, most of them have the same answer to the market rally. The Fed has printed trillions of dollars, so the massive liquidity supports and pushes equities higher. We also know the Fed has purchased about $1.3 billion in ETFs , mostly corporate bond ETFs. But is it really the reason?

The chart below shows the size of the Fed's balance sheet. As you can see, since March of this year, the Fed's balance sheet has grown by more than $3 trillion. Now that's a massive liquidity injection!

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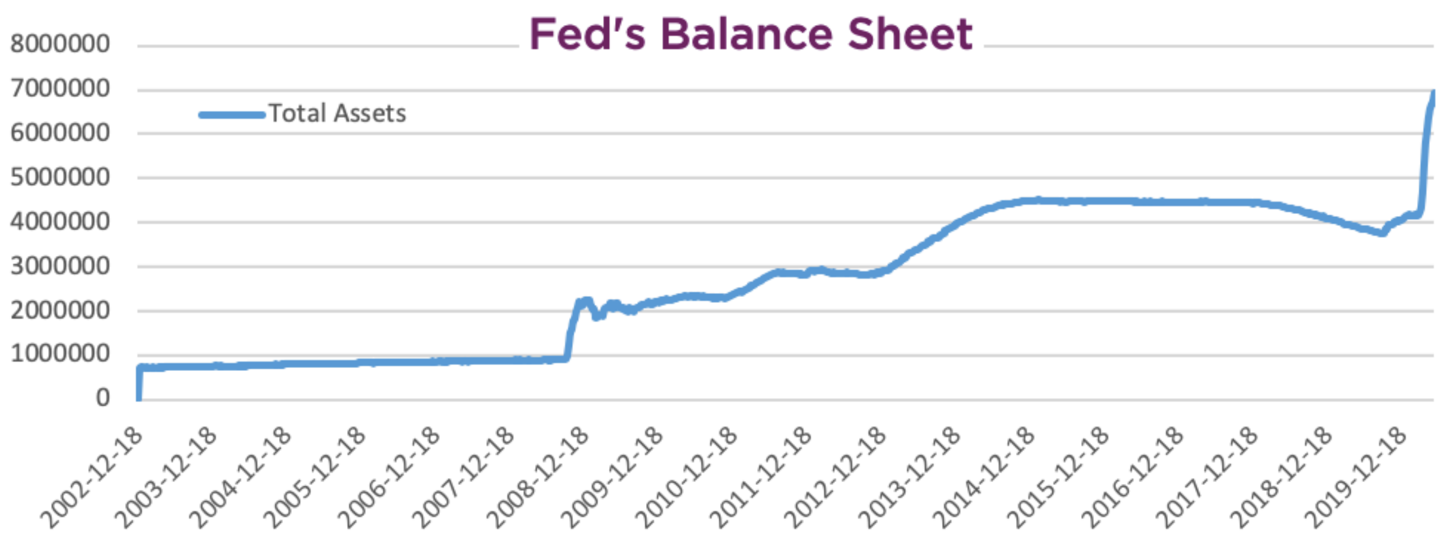
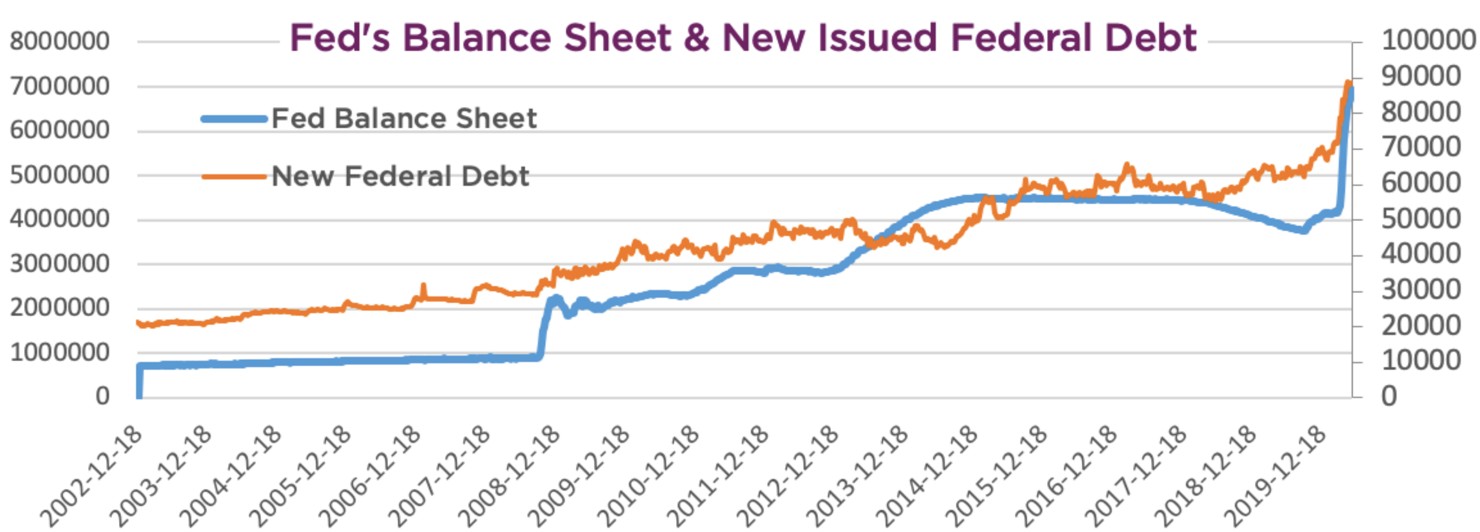


Source: Omnia Family Wealth; FRED

But the Fed has two very large mouths to feed: the financial market and the US Treasury. As you can see from the next chart, since the beginning of the crisis, the US Treasury has increased its debt issuance dramatically (orange line), and they plan to issue much more. The Fed is buying the majority of the debt and basically funding the government and the fiscal policy to support individuals and the economy. So, as the government needs to raise more debt, the Fed will need to print more dollars to purchase the debt.



Source: Omnia Family Wealth; FRED

The net result is that the liquidity in markets is significantly lower than what is perceived. In the chart below, we subtracted the weekly growth in the Fed's balance sheet (or new money printed) by the new debt issued by the Treasury. As you can see, liquidity is actually flattening.

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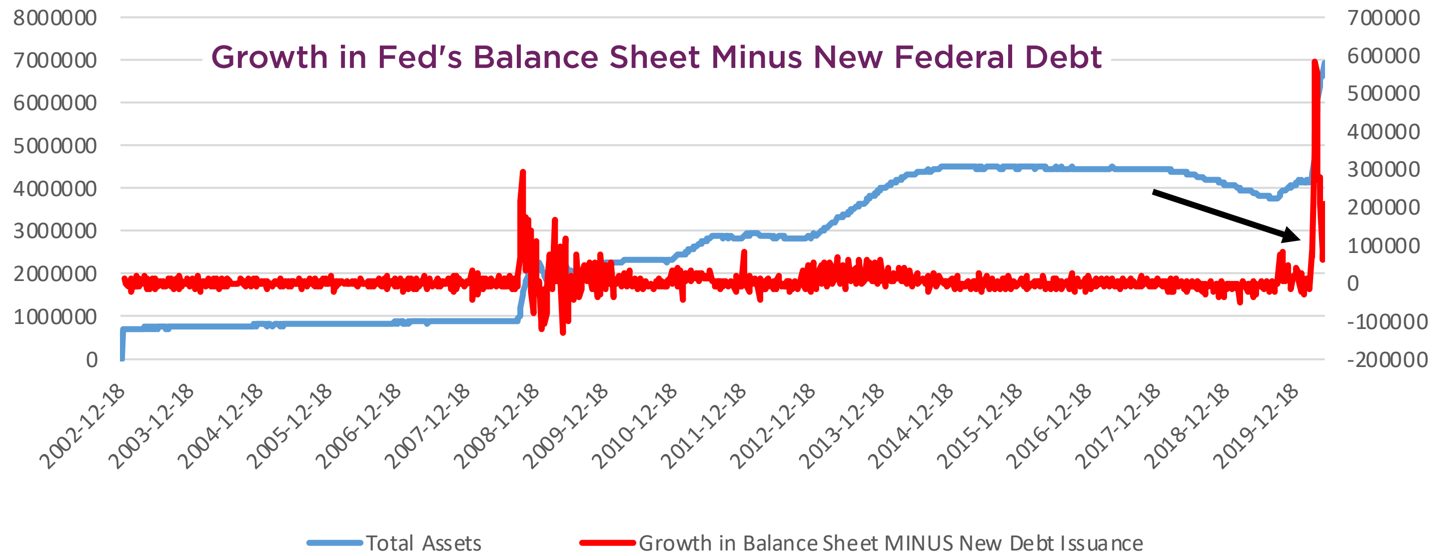

Source: Omnia Family Wealth; FRED

The immense issuance of new debt by the government is "sucking" dollars and liquidity out of the world economy that is starving for dollars. If debt issuance grows higher than Fed purchases of the debt, we could see a higher dollar, which is very bad for risk assets.

We're not surprised. This is all part of the long-term debt cycle we wrote about in 2018. There's no going back for the Fed. The Fed is stuck in a vicious cycle. They must keep buying US treasuries to fund (monetize) the US government debt, and its stimulus programs. That is causing upward pressure on long-term rates, but because we can't afford higher rates, the Fed will keep buying treasuries to keep rates lower. This is what we call curve control. **The most important shifts in markets take years to develop, but unless you have a continual process to identify and prepare for them in advance, when they occur it's sometimes too late.**

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