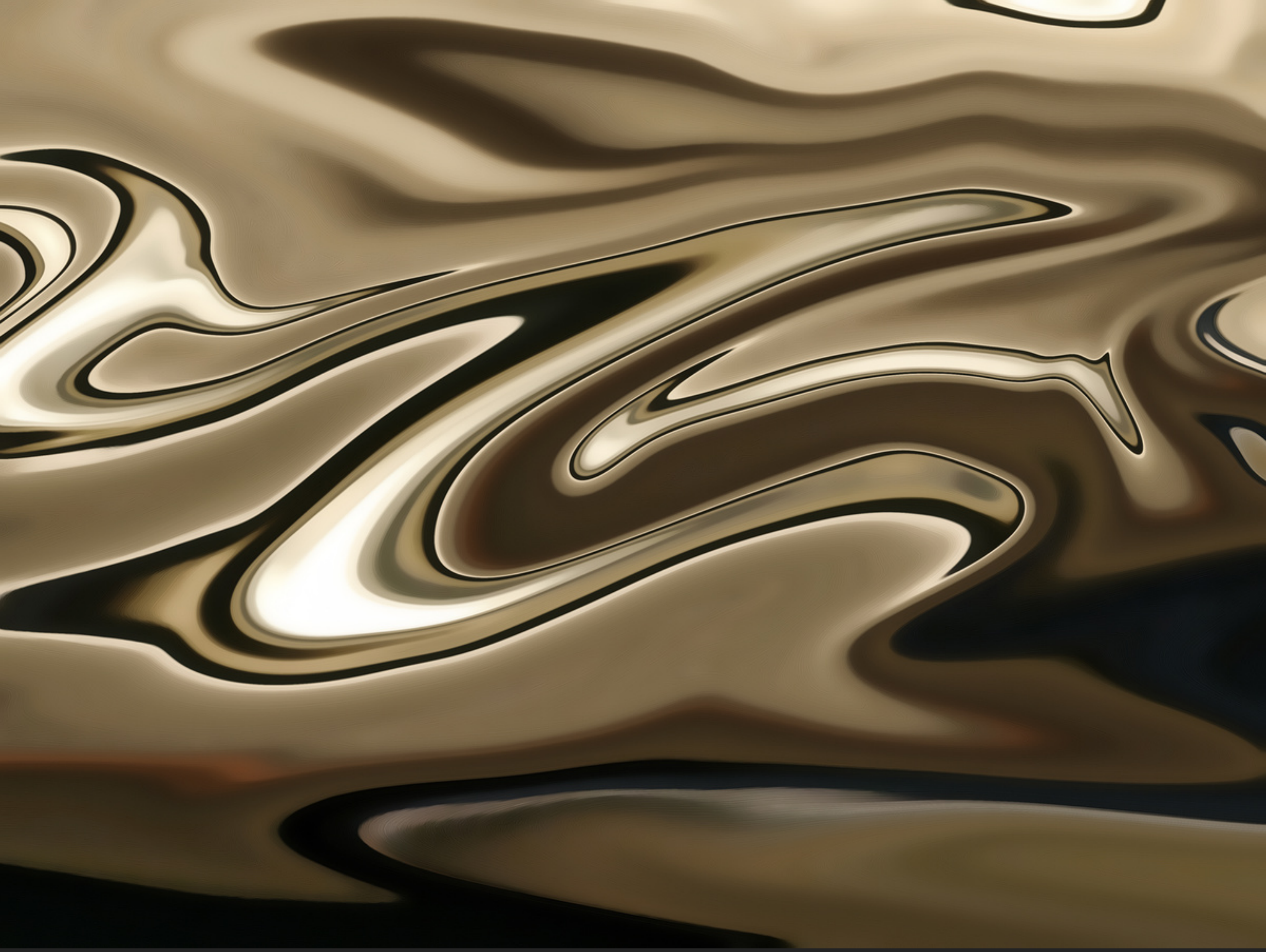

UNIO

Liquidity Matters

Unio Global Macro Committee Outlook

April 2024

Liquidity Matters

We should speak more often about financial market liquidity. In an age when, since the global financial crisis, central bank balance sheets have been a very significant driver of asset prices, liquidity is a core theme.

In a very simple sense, liquidity relates to both the ease of access to capital in addition to the ability to trade underlying assets. Yet, while ‘liquidity’ is one of the five pillars of our investment process, arguably many investors do not focus on this factor in enough detail.

From an investment perspective, we think of liquidity more specifically as the complex plumbing, or microstructure, of financial markets, and like the art of plumbing blockages or flows, the knock-on impact this can have on asset prices. Drilling down further into the financial market ecosystem, we can frame liquidity in at least three different ways.

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The first relates to the quantum of money that central bankers are driving through the system (such as M2 money supply), offset by the level that governments are taking out (through bond issuance for instance).

A second related measure is the quality of credit and banking liquidity, and the extent to which in moments of financial stress, financial institutions have access to money. In particular, changes in the financial industry, most notably the growth of the private credit sector, have made it harder to detect the quality of this form of liquidity.

A third facet in the liquidity debate is the quality of liquidity in financial assets between buyers and sellers making a market, that is, the sense of the difference in bids and offers for specific assets, and the extent to which capital flows easily between similar assets.

According to bodies like the International Monetary Fund (IMF), as financial market infrastructure has become more ‘industrialised’, this aspect of financial market liquidity has deteriorated.

Europe’s opportunity

In the context of the Unio view, we note two issues at least.

The first is that market liquidity seems to be more constrained, and across asset classes there appears to be building position risks in the sense that a large number of investors are deploying very similar strategies, and could thus all be caught offside if the investment climate changes.

The second is that central banks use the narrative around liquidity to guide investors as to the path of interest rates. Here, the stated ‘decoupling’ of the ECB from the Fed may – in the context of stubborn inflation – see a stronger dollar, something that is associated with lower liquidity, and commensurately a weaker euro – which could well boost export oriented European equities.

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