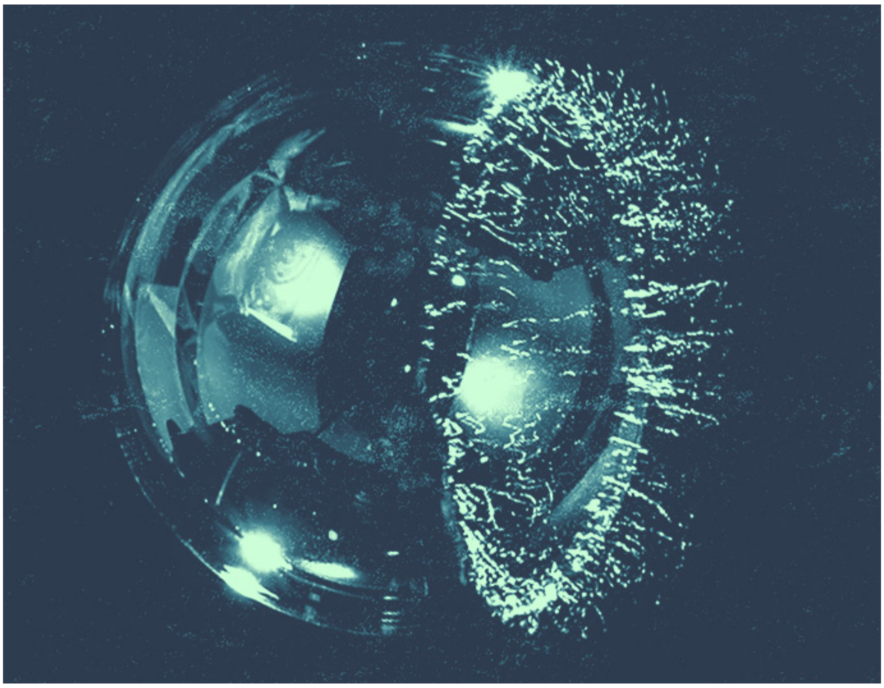
LIQUIDITY: BUBBLE STOCK WATCH

Two spigots of global liquidity are being turned off: Central Bank QE and Global FX Reserve Accumulation. Patterns to watch in the bubble stocks as the bathtub drains.



September 14th 2018

Liquidity: Bubble Stock Watch

Liquidity Spigots are Being Turned Off

As a precursor to discussing the vulnerability of some high-flying stocks of the last few years, I want to refresh your conversance with two important sources of global liquidity*. The first is Central Bank QE, with which you are all familiar but the second – and far less well understood – is the role of reserve accumulation as a pool of liquidity.

*For a more in-depth analysis of the framework, please dip back into my *Meeting of Minds* piece from November 2017.

QE Full Steam Ahead

Since 2008, the Fed has adopted QE as the monetary tool of choice. They were later joined to varying degrees by the ECB, Bank of Japan, Swiss National Bank and Bank of England. The result is that in 2016, at the peak of QE frenzy, the printing presses of the 'Big 3' (the Fed, ECB and BoJ) were expanding their balance sheets at a cumulative annual rate of USD 2 trillion.

Fed First to Instigate QT

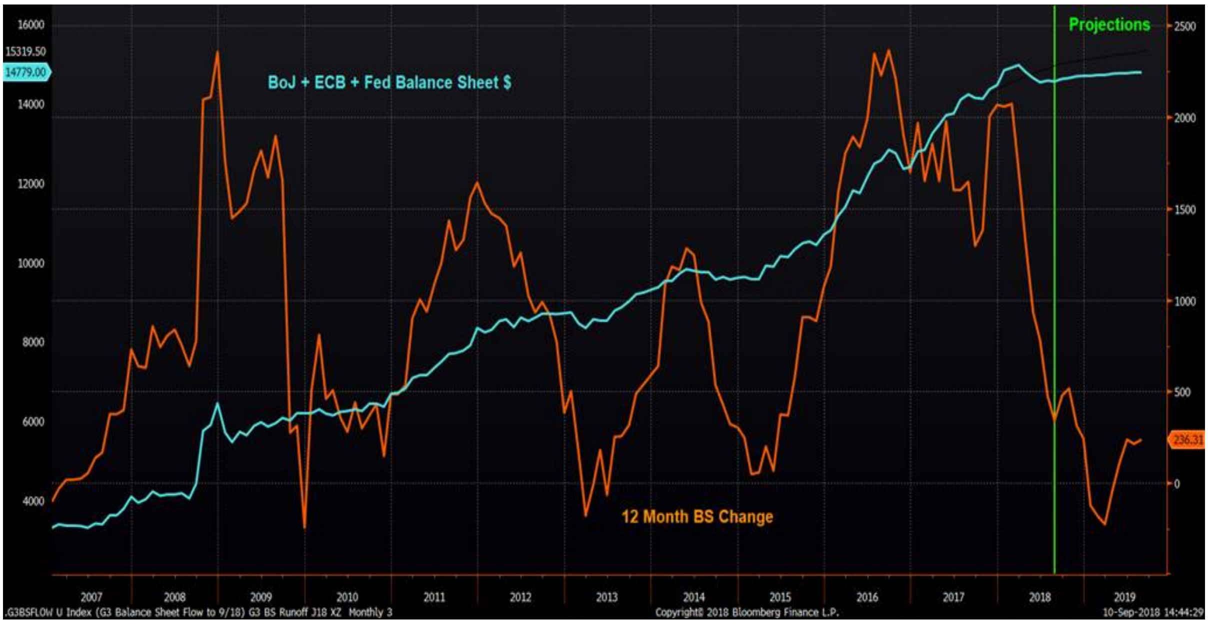
However, once again led by the Fed, QE first slowed and has now moved into reverse. Slowly but surely, they have accelerated the pace of balance sheet reduction or Quantitative Tightening (QT). In the case of the Fed, this means that during Q4 their drain will ratchet up to $50 billion per month.

While in Europe, even though the ECB is still applying the monetary juices, they have announced a series of QE reductions which are slowing its expansion. The next decrease from EUR 30bn to EUR 15bn also kicks in from the end of this month with a reduction to zero pencilled in for Q1 2019.

That leaves the BoJ as the only major Central Bank still expanding its balance sheet indirectly via a policy of Yield Curve Control. That policy is adding around JPY 6.8 trillion per month (just over USD 60 billion) to their balance sheet.

From USD 2 Trillion to Nothing

Below we have summarised all these policies into a simple chart. It shows that from the 2016 highs to now, that the rate of balance sheet expansion of the Big 3 has fallen to a modest USD 200 billion. It will drop even further in Q4 as the Fed accelerates QT, and again into 2019 as the ECB ends QE completely.



Financial Repression

This is all incredibly significant because QE formed an important part of the financial repression policy landscape, which encouraged risk-seeking behaviour across all investor classes from institutions to retail savers.

Not all QE is equal, and asset choices vary greatly from region to region. However, it is fair to say that money flooded overseas as savers in the developed world, and especially in the US, were repressed.

One of the biggest beneficiaries was EM and, as cash rolled into these predominantly mercantilists countries, they were keen to keep their exports competitive. So, with the dollar falling, they sold their currencies and, in the process, accumulated foreign currency reserves. Export competitiveness aside, this had the secondary effect of further adding to global liquidity because, as this pool of reserves grew, they were reinvested back in markets. Hence, just like the Big 3's QE, they suppressed bond yields and pumped up equities.

Reserve Accumulation Halts

However, just like QT, this virtuous circle is now reversing as the dollar strengthens. No longer are these EM nations faced with excessively strong currencies, but quite the opposite. As a result, the necessity for FX Reserve accumulation has vanished. Some important countries like Turkey and Brazil have needed to intervene to stem the free-fall of their currencies. This process requires them to sell their hard currency reserves (and the assets they hold in them like T-Bills and US Treasuries) to purchase their local currency in the open market, aka QT.

The chart below relies on somewhat dated IMF COFER data, but the pattern is clear. As the rate of change of USD appreciation has accelerated (here inverted in blue), the pace of reserve accumulation has declined.

In this process, China as the world's largest reserve manager has played a key role.

As the dollar started to appreciate from 2014 onwards, you can see that broadly speaking her reserves have fallen. They did pick up somewhat unspectacularly in 2017 as USDCNY dipped, but as it reaccelerated this year once again, reserve accumulation has ground to a halt. (Bear in mind, even "unspectacular" was a big nominal number of over USD 165 billion from January 2017 to January 2018.)

Effects

Enough of the liquidity analysis for now. Let's look at effects:

As liquidity has drained, fissures have become increasingly apparent in a broad range of assets. Front and centre has been EM where both debt as well as equity markets, have suffered badly over the last six months. I won't rehash the reasons here, because they have been a major theme of my contributions to *Macro Insiders* since the inception of the service.

Decoupling and Crowding-in

Ironically, one corollary of the changing dynamics has been that far from joining the sell-off, US markets have benefited. Whereby, as the dollar has strengthened it has created a crowding-in effect; sucking cash into the US, only to turbocharge the divergence between EM and US high-flying technology stocks.

I dealt with this in last month's *In Focus: USD, EM and Recoupling*, but the effect is perfectly illustrated in the chart overleaf, which shows how since Easter, the Nasdaq (NDX) has outperformed the MSCI Emerging Market Equity EFT (EEM) by over 25%.

Policy Backdrop

That brings us to the Federal Reserve's intentions because, while hours of airtime have been taken up debating the FOMC's policy reaction function and their sensitivity to EM fallout etc., I want to make two simple observations about growth and inflation.

Growth

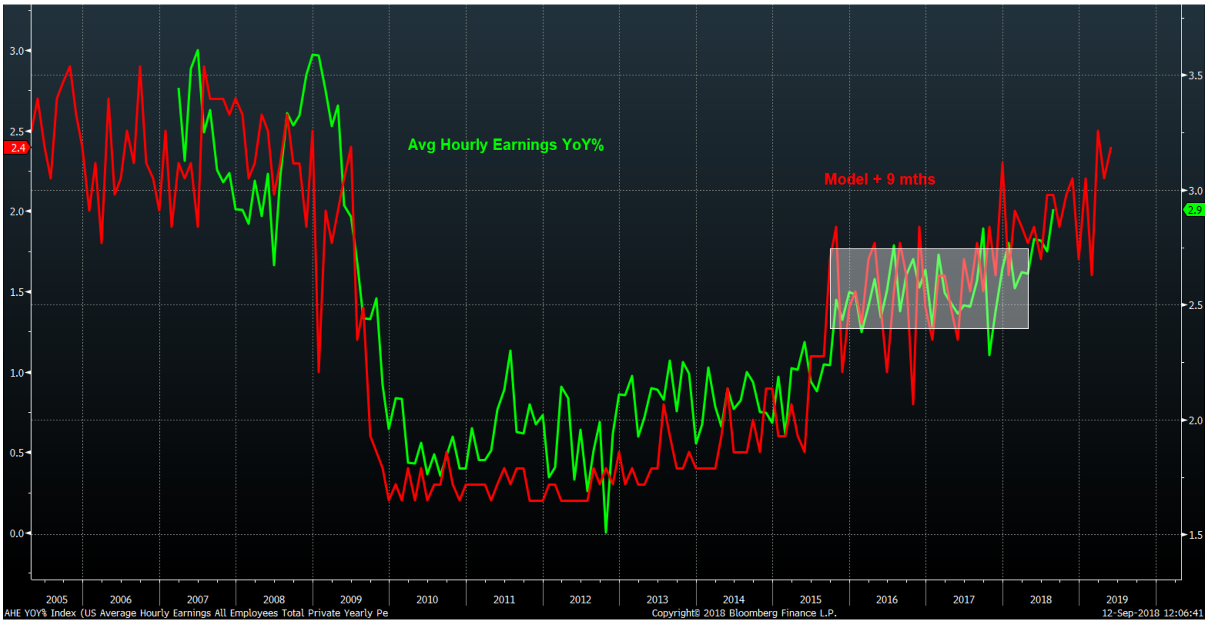
US growth remains robust because continued relatively-easy monetary policy has allowed financial conditions to stay easy while the economy has also received a pro-cyclical boost from the Trump Administration's fiscal expansion implementation.

Loose money combined with loose fiscal policy creates growth (at least in the short-term). But the risks to sustainability arise if you believe there are nascent inflationary pressures building in the system.

Inflation

At MI2, one of our biggest concerns has been that as the economy started to run into capacity constraints and rising costs, especially in the labour markets, we faced the risks of both higher inflation and wages.

We got a hint of this a few days ago as Average Hourly Earnings popped higher in the monthly BLS Employment Report release, bringing the Philipps Curve question back into focus (this tries to quantify the necessary level of unemployment that is sufficient to give labour the bargaining capacity to push through higher wage settlements (wage inflation)). My work suggests wages will push on above the 3% annualised growth level in the coming months. The chart below shows one forward-looking model I like to follow.



Gangbusters

When added to YoY real GDP of around 3%, this inflationary backdrop continues to suggest that nominal growth is going gangbusters. Ergo, why should you expect the US Federal Reserve to get cold feet about continuing their hiking process? We will get more on this from the FOMC Statement after the meeting on 26th Sept, but at this stage we would expect them to hike in December and again in March.

So, let's start drawing the disparate threads together.

- QE (which initially floated all boats) is long in the tooth and due to turn into global QT imminently. This is tightening liquidity, especially in the dollar.
- EM has already reacted badly as the dollar has risen, and Reserve Accumulation has (at best) ground to a halt but may be adding to QT already.

- In the process, dollar strength is further exacerbating the effect by sucking liquidity into the US. This is enabling US assets to decouple from the rest of the world.
- Loose monetary and fiscal policy are supporting US growth. Finally, wages are beginning to rise as the labour market tightens.
- With Q3 US Nominal GDP set to exceed 5% annualised, the FED will keep hiking.

Cut to the Chase

In theory, this all looks great for the US. Unfortunately, there is a dark side, because in the process we are starting to see bubble patterns in several of the market darlings. **Please note: I am relying here on a chart pattern analysis not a valuation methodology, so the important thing is to consider levels and prepare action plans whether you are a committed bull or a frustrated bear.**

Déjà Vu

Having worked through the dotcom boom and bust at the turn of the millennium, I can't shake an unnerving sense of déjà vu.

Back on 19th July, I sent a Flash Update on Netflix and FAANG stocks, where I made some similar references to Cisco in the early 2000s. I will start by reproducing the chart of Cisco to set the tone. (Right at the bottom of this piece is a crib sheet on my Classic Bubble framework with a bit more explanation).

Tipping Point

Before this year-end, as risks assets face the challenge of price discovery without the benefit of unfettered, policy-induced liquidity (as discussed above), we believe we are likely to hit a tipping point.

If things take a turn for the worse, the most prominent victims are likely to be the stars of the previous cycle: high beta plays that have been the beneficiary of Central Bank and especially Federal Reserve generosity.

Emerging Markets I have discussed before and above. But as the liquidity noose tightens, even domestic US superstars are likely to become victims.

Parallels

Take another look at this Netflix chart. The parallels to Cisco are disturbing.

Since the July piece, Netflix has fallen quite sharply. This makes me more confident that the move to $420 and subsequent loss of momentum has completed its 'blow-off top', which suggests we now enter the 'Bust' phase.

Thus far, while the stock has tried to bounce, it has failed at $378.50. This suggests that we now have a neckline in place. That, in turn, opens up the possibility that we have already closed the 'bull trap'.

If we have all the above in place as I suspect, ***then it's time to run for the door.*** That's because, as I explain in the appendix, once that trap is sprung, you can be pretty sure you are in for a period of terrible performance.

Caveat

Annoyingly, I must introduce a caveat. For my taste, the initial sell-off has been a little too shallow at only a little over a 25% dip off the June highs. When compared with Cisco's initial 40% swoon in early 2000, that's positively provincial and would rank at the lower end of the typical drop we see in these types of dips.

But either way, the chart suggests you should still be short even if we haven't completed the down leg of the bull trap. A down-move could see us fill a significant gap on the charts at $228 before we get a major bounce.

Tactics: go short or stay short with a stop above the gap at $391.75; reassess around the $240 to $230 zone for a 3:1 reward ratio

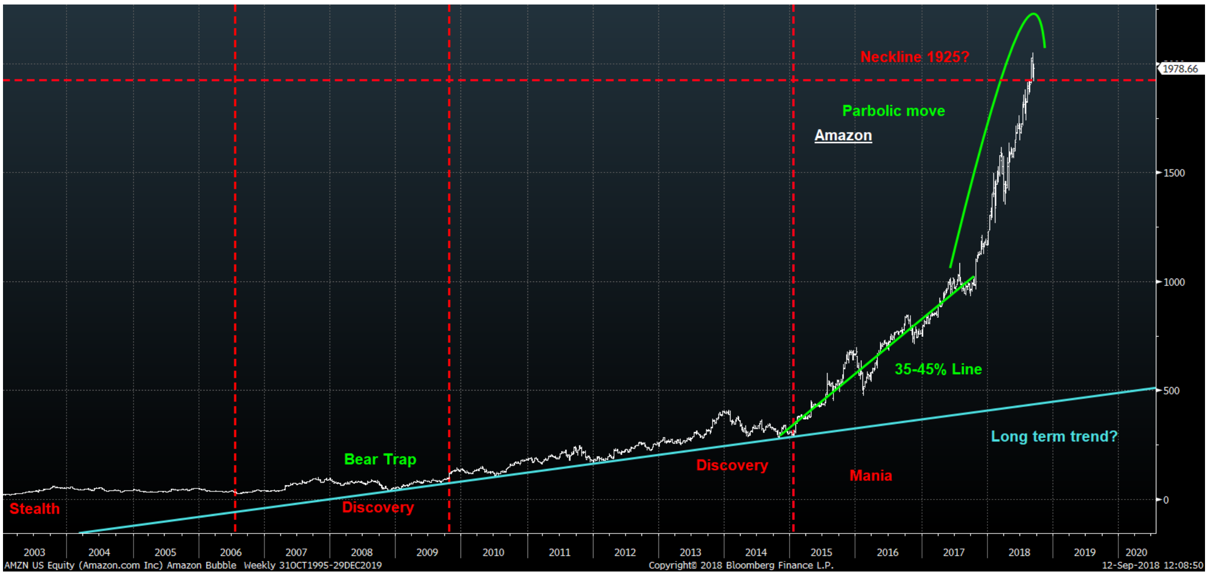
Behemoth

That brings us to Amazon. The real behemoth?

90% plus of analysts have a buy recommendation (career risk in play for them and, after all, it is only OPM ('other peoples' money')). It seems sacrilegious to suggest that we might have a top in place. But as I stressed above, **I am not interested in fundamentals in this context, just chart patterns.**

The doubling of the stock since the end of last October, which in the process has added a mind-blowing $500bn in market cap, certainly counts as a parabolic move, i.e. the blow-off final move of the 'Mania' phase. As we've discussed, while these moves always look like they can go to the moon, the reality is that is that just like a jet fighter that goes vertical at some point, it runs out of oxygen or, in the case of Amazon, marginal buyers to suck in. That's a tipping point, because it doesn't fly off to the side but loses momentum and drops sharply.

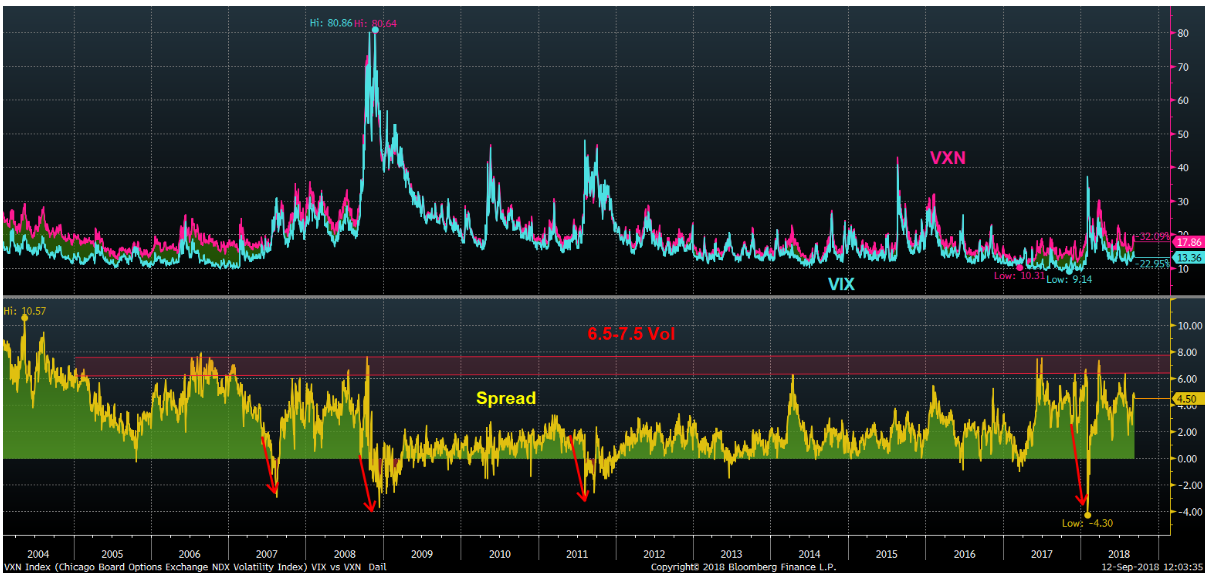
Thus far, the evidence that we have reached such a point is very scant. At this point, I am advocating that you watch this stock very carefully, especially $1925, which has the possibility of becoming a neckline of the blow-off top, i.e. the equivalent of the $378.50-385 level on Netflix.



Decision Time

Together with this level, I want to add a simple but quite neat little metric based on relative implied volatility: the spread between the VIX and VXN (the Nasdaq vol contract). Once the VXN is 6.5-7.5 vols over the VIX, it's decision time.

Typically, at that point the Nasdaq bounces, the VXN dips and order is restored.



However, as we saw in early 2007, 2008 and February's vol shock, occasionally what happens is that the VIX starts to play catch-up to VXN. That's bad news. The thing that worries us so much about Amazon is its dominance in some ETFs. For example, it is over 20% of XLY and IYC. If it does start to dip sharply, the fallout won't be contained by the Nasdaq.

Conclusion

Additional liquidity, as provided by Central Bank QE, is declining rapidly; reserve accumulation has ground to a halt; the Federal Reserve is staring at annualised nominal GDP of 5% or more in the face for Q3 and will be hard-pressed not to continue with rate hikes. This is already pressuring EM, which until recently was considered 'the trade of the decade'. However, at some point, it could even threaten US darlings, where crowding-in has taken high-flying stocks into bubble territory.

Be prepared

Using the framework of Cisco, Netflix and Amazon above, it is worth dipping into the chart patterns of other bubble candidates that my filter has identified as likely to be exhibiting the parabolic move of the mania phase. In each case, what is most important for the bull market to continue is that they maintain their momentum.

AMZN NVDA ADBE NFLX CSX ATVI ISRG ADSK IDXX CTAS

ALGN SIVB IAC TTWO ODFL CPRT ABMD ICLR CACC FIZZ

MPWR ICUI NEOG STMP AMED TREE MMSI EBIX RGEN

AAXN SAIA PLUS CVCO MGPI QDEL AXGN JOUT STAA RDIB

Appendix: *What's a "Classic Bubble?"*

The first thing is that behind any bubble there lies a great fundamental or macro story. You never create a bubble in a lousy asset. In addition, you need liquidity. Historically this is provided by excessively loose monetary policy such as the Fed's special liquidly facilities offered ahead of Y2K which powered the Nasdaq's parabolic rally in 2000-01.

Alternatively, that liquidity can also come from abroad, frequently from foreign investors attracted by a rising currency. These investors then look to 'double-dip', taking advantage of the rising currency to invest in domestic assets.

The classic example occurred post the 1985 Plaza Accord when continuous G5 intervention to weaken the dollar attracted money into a rising Yen helping to fuel the Nikkei's bubble. These are the perfect conditions for a classic bubble. Whether you are talking about the Saudi stock market in 2006 or, as you can see below, in silver in 2011, all bubbles have very distinct chart patterns with four clear phases: Stealth, Discovery, Mania, and Bust.

The first phase, Stealth, is when smart money buys.

We then move to Discovery as the institutional money enters. This period typically ends once the price of the instrument has doubled and existing owners liquidate into a bear trap.

The third phase, Mania, kicks off as retail money piles into the trade. This initially drives prices up at about a 35-45-degree rate and eventually goes parabolic as greed overtakes logic. At some point, a neckline is created either before or after the blow-off top.

Once we break back down below the level of the neckline, it acts as the resistance to contain any rally, which sets us up for a bull trap. ONLY when the trap is sprung can you safely bet that the top is in and we get the first significant liquidation as part of the Bust phase. This is the least scripted of the phases as it can sometimes unfold rapidly over a few months, as with Cisco in 2000, or over years, as with the Nikkei in the 90s. However typically, the asset drops in a series of cascading waves with each one finding temporary support from trend lines or prior bands of consolidation.

The ultimate price target for any burst bubble is the long-term trend line.

BACKGROUND

Julian Brigden is a widely respected commentator on the global macro environment. He is the Co-Founder and President of Macro Intelligence 2 Partners. He has over 25 years of experience in financial markets and has held positions in market and policy focused consulting to hedge funds and banks as well as in FICC sales.

Julian was the Managing Director of the G7 Client Team at Medley Global Advisors from 1999 to 2004, a leading macro policy intelligence firm providing timely trading recommendations. From 2004 to 2011, he served as North American Head of Hedge Fund Sales at Crédit Agricole. He has worked in London, Zurich, New York and Vail at UBS, Lehman Brothers, HSBC, Drexel, Credit Suisse, and Salomon Brother in foreign exchange and precious metals.

As a global macro strategist, and not a journalist or economist by training, Julian's primary focus is understanding and explaining macroeconomic and policy related developments to help our clients position portfolios and/or exploit trading opportunities. Julian and the team are particularly skilled at exploring correlations in the economy and financial markets which are vital to a vast array of investment decision makers.

Julian has been featured on Bloomberg, CNBC, the New York Times, Wall Street Journal and in Barron's among others for the firm's research on EM, liquidity, QE, bubbles and global FX.