Liquidity Squeeze? Or Not?

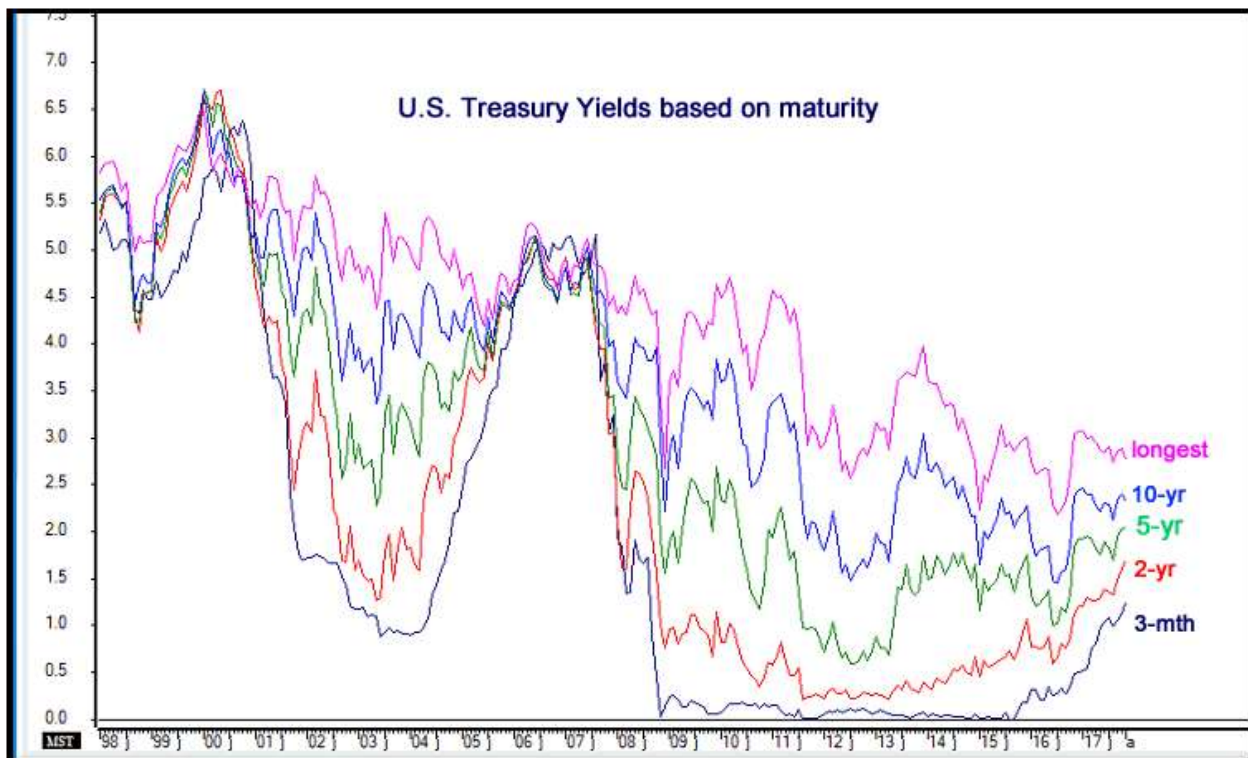
Earlier today one of our clients telephoned that he had just read where a certain financial journalist advised that a liquidity squeeze was occurring and that the stock market would respond with a 50-percent drawdown.

That's scary, and part of it is true. But the truthful part is an "if – then" statement. Specifically, IF there is a liquidity squeeze, THEN you can expect the stock market to drop. There have been two such incidents within the last 20 years. But let's see if there is any evidence of a liquidity problem.

When liquidity becomes precious the cost of short-term financing rises faster (and in some cases farther) than that of long-term financing. The relationship between the different rates is referred to as the term structure of interest rates or the yield curve. Here are those current rates:

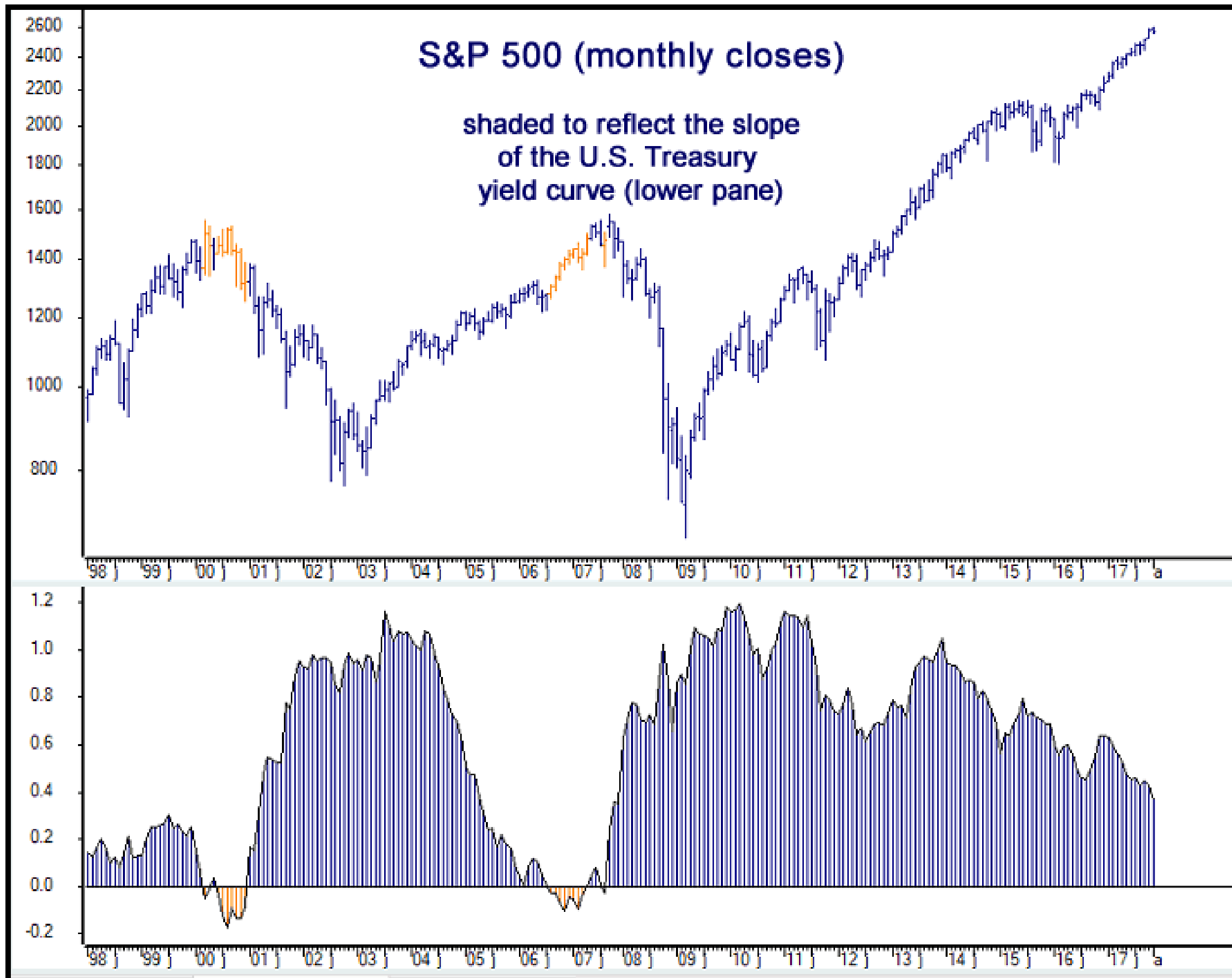
	3_mth	2_year	5_year	10_year	longest
20171109	1.238	1.637	1.998	2.324	2.808
20171110	1.241	1.641	2	2.326	2.806
20171113	1.223	1.671	2.068	2.404	2.875
20171114	1.259	1.691	2.067	2.378	2.836
20171115	1.251	1.687	2.04	2.324	2.765

Over the last 20 years the relationships have changed quite a bit:



Most of the financial practitioners look at the rate difference between two maturities, such as the 3-month vs. 10-year or the 5-year vs. 30-year (longest). We prefer to look at the relationship of all five, and we do that by putting a regression line through the five, and then calculating the slope of that regression line for each day. With the right tools it is an effortless calculation.

Then you can plot the slope across time, and while we are doing so, let's see how it has impacted the stock market:



Note that the yield curve slope gave substantial advance warning of the last two major declines, and that at this time it is not signaling such a decline. But the yield curve is not the sole arbiter of equity declines: there have been substantial declines (1998, 2010, 2011) that were not signaled by the yield curve. So we could easily have a big decline caused perhaps by overvaluation or some external force that would not stem from liquidity issues.

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Okay to circulate.