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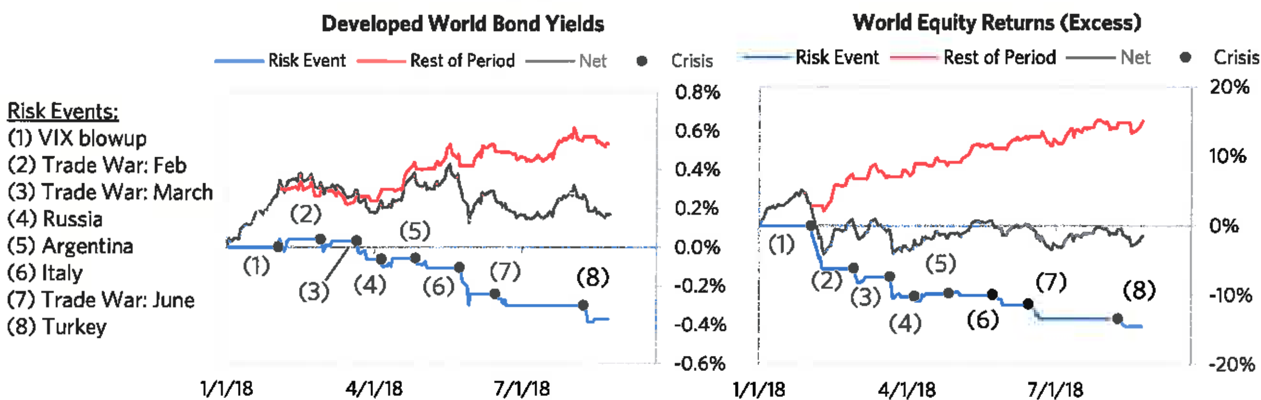
# Lots of Risk-Off Events with Little Follow-Through Reflects Important Money and Credit Dynamics

There have been a lot of "risk events" this year, but so far none has triggered a significant contagion to more permanently impact a broader set of economies and markets. Both the events and the lack of contagion associated with them reflect key underlying forces driving economies and markets. A pullback in money has led to a tightening of liquidity, drawing yields gradually higher and triggering squeezes where vulnerabilities to liquidity are highest. The financial system has remained accommodative, enabling a sufficient flow of credit to sustain positive momentum in global economies. And after a decade of deleveraging, the tightening is occurring into an environment where few players are liquidity-dependent and vulnerable, so there's not much pervasive susceptibility for these sparks to ignite into a broader crisis. Zooming in on the market action, the forces become more apparent. "Crisis" days have triggered the normal flight to quality, which then reverses as the event fades into distant memory. Cutting across these bouts of risk-off and then reversal, the market movements have reflected the underlying forces of monetary tightening putting upward pressure on asset yields, while the financial system is creating enough credit to keep the expansion going and to generate earnings growth. Going forward, we'd expect more of the same until a more dramatic tightening of monetary policy puts enough pressure on assets to break through the fire wall and send the self-reinforcing process of spending, income, and credit creation in the other direction.

The charts below dissect this year's market action in global equities and developed world bonds into the market action in the week after risk events (blue line), the rest of the time (red), and over the full period (gray). You can see how the reactions to the events have been conventionally risk-off, but the carry forward has been minimal due to the forces described. Net, there has been a small rise in bond yields and flat equity returns.

**Cumulative Market Action This Year**

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The next table provides more detail on the market action around the events. Across markets, risk events have triggered a flight to quality (column one), with the areas where the liquidity squeeze hits (European sovereigns, parts of the emerging world) showing the biggest cracks. Outside of these risk events, market action has reflected a degree of normalization to go along with the ongoing pullback in liquidity with sustained economic growth (column two). The net is reflected in the third column.

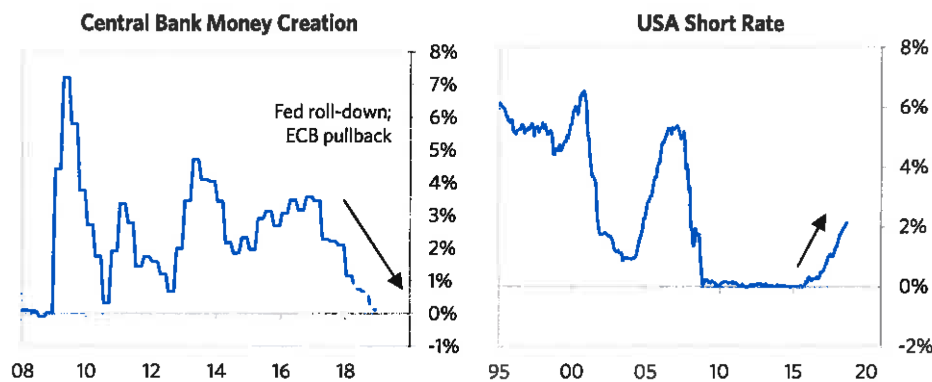
## Global Market Scan

| Asset Class | Asset | Cumulative Market Action During Risk Events | Cumulative Market Action Outside of Crisis | Cumulative Market Action (YTD) | |
|---|---|---|---|---|---|
| **Bonds** | USA | -0.46% | 0.88% | 0.42% | DW yields fall in crisis, rise throughout year |
| (Yields) | DEU | -0.51% | 0.42% | -0.08% | |
| | JPN | -0.05% | 0.09% | 0.04% | |
| **Equities** | USA | -16.2% | 28.6% | 7.7% | Equities sideways over the year outside of US |
| (Returns) | WLD | -16.7% | 18.2% | -1.5% | |
| **Spreads** | EUR Sovr | 0.8% | -0.4% | 0.4% | Spreads sell off over year, driven by risk event periods |
| (Yields) | EMD | 0.9% | -0.1% | 0.8% | |
| | USA Corp | 0.4% | -0.2% | 0.2% | |
| **CMD** | Gold | -6.1% | -2.2% | -8.1% | |
| (Price) | Oil | -18.2% | 37.1% | 12.2% | |
| **FX** | USA vs TWI | 0.8% | 0.2% | 0.9% | Dollar up across period, especially against EMFX. Yen up mostly in risk events. |
| (vs USD) | EUR | -3.5% | 0.1% | -3.4% | |
| | JPY | 4.6% | -2.6% | 1.9% | |
| | EMFX | -9.8% | -4.0% | -13.4% | |
| | CHN | -3.3% | -1.6% | -4.9% | |

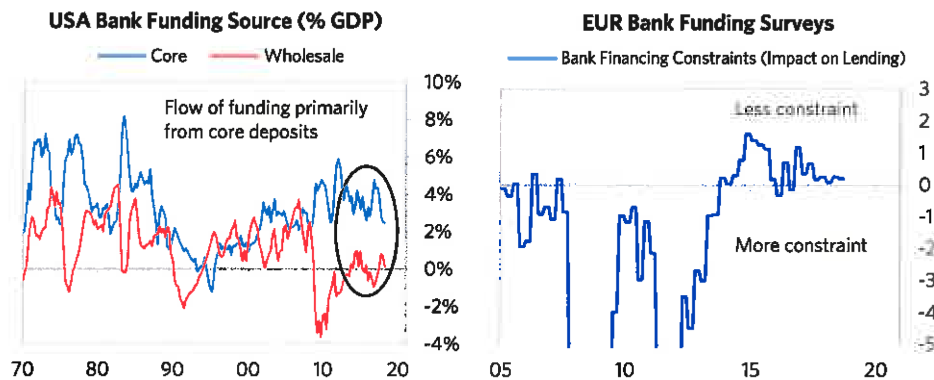
**A Summary Picture of the Underlying Forces**

The underlying forces are as we've described in more detail in prior *Observations*, but to connect them to the market action we will hit a few highlights.

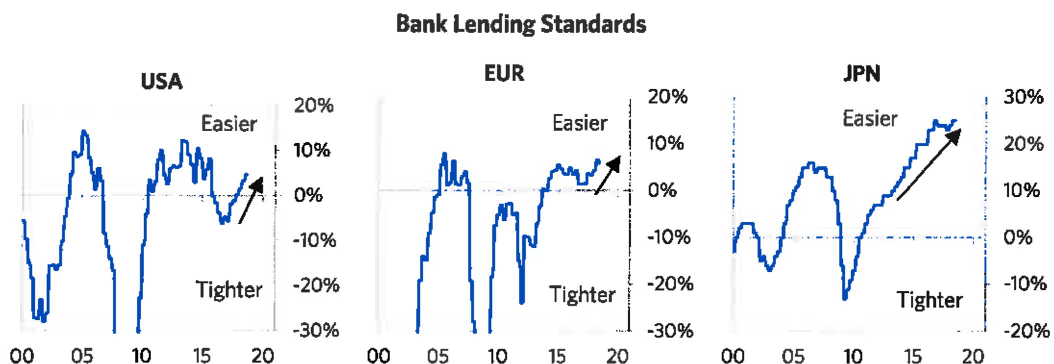
The dominant force behind the market action this year has been the gradual rolling over of money and credit, which reflects a tightening of monetary policy alongside a financial system that remains accommodative. The charts below show the contraction in money creation and the rise in US short-term interest rates.




The financial system has about as much capital as ever and is funded by core deposits rather than hot money. A lower than normal susceptibility to a pullback of credit to the financial system leaves less vulnerability to the financial system pulling back credit from the real economy. Data and surveys on the banks' funding situation paint this picture. The left chart below shows the mix of funding going to US banks, which is primarily made up of core deposits rather than wholesale funding—a more stable mix. The right chart shows European banks' assessment of whether financing conditions are a constraint to lending, which shows little reason for concern.




With limited pressure on funding and continued positive economic momentum, banks continue to have accommodative lending standards.



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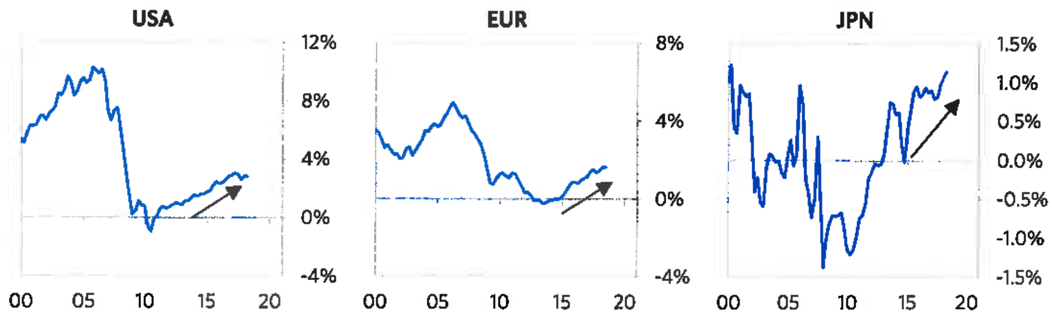
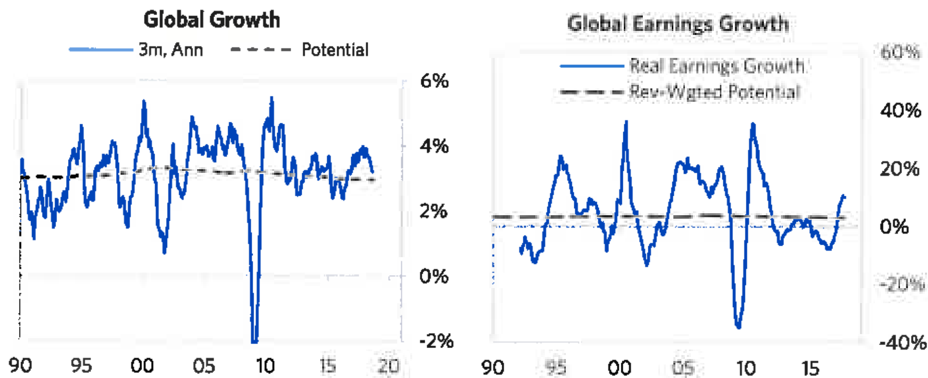
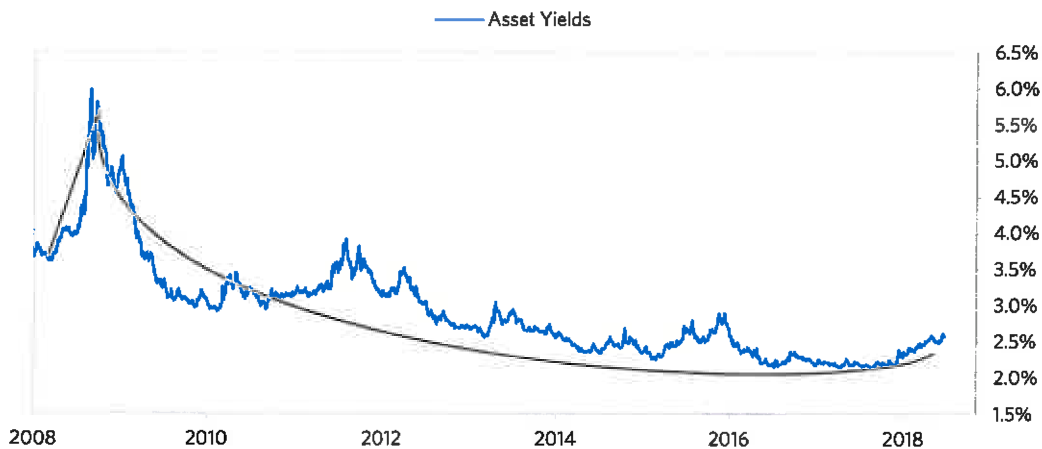
This in turn has allowed for a continued upswing in credit creation, supporting consumer demand and offsetting the effect of the pullback in money on the real economy.




The financial system has supported continued momentum in underlying conditions. As shown below, global growth remains above potential. This in turn has been an ongoing support for earnings.




The net effect of the pullback in money and the expansion in credit has been a gradual pullback in liquidity, but one that, given its complexion (less money but ample credit), has hit financial markets more than the real economy. The effect on financial markets is evident in the continued gradual rise in asset yields.



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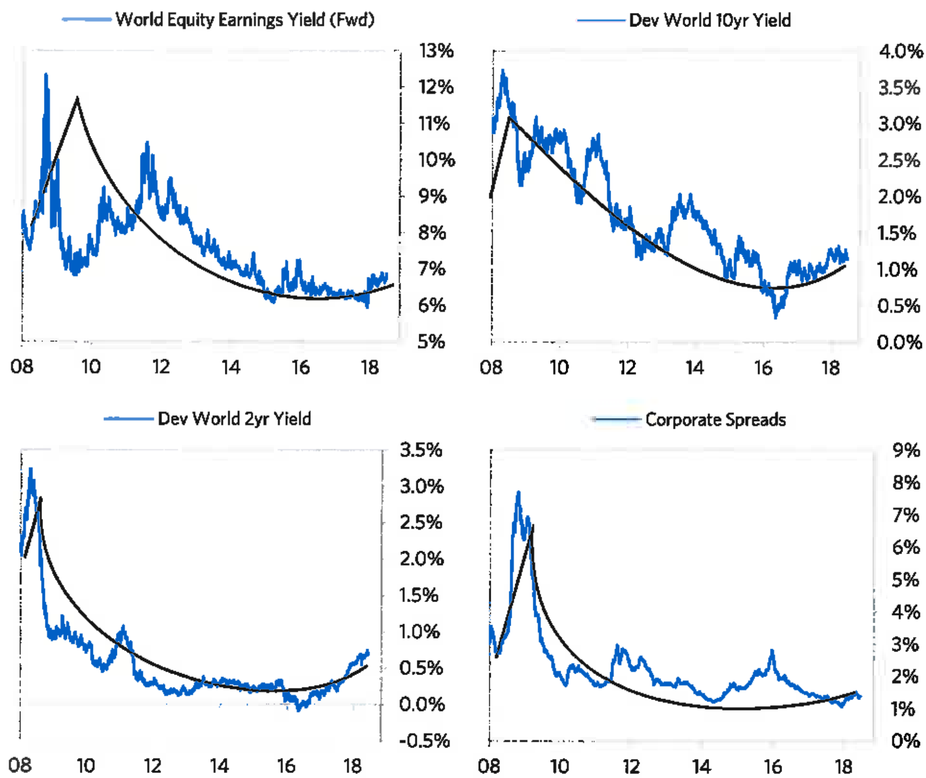
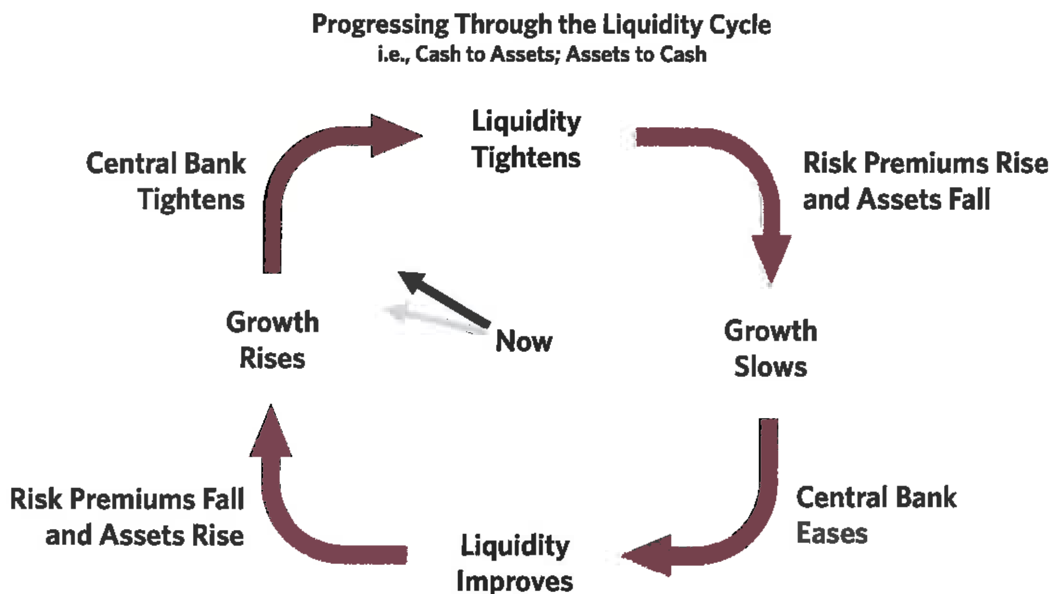



Going forward, the risk is that liquidity conditions will tighten enough that they push risk premiums sharply higher, leading to a decline in credit creation, less spending, and contracting economies. That would normally be what comes next, as illustrated by the following liquidity cycle. Given the conditions described, the rate of change through the cycle is unfolding gradually.

**Progressing Through the Liquidity Cycle**
**i.e., Cash to Assets; Assets to Cash**



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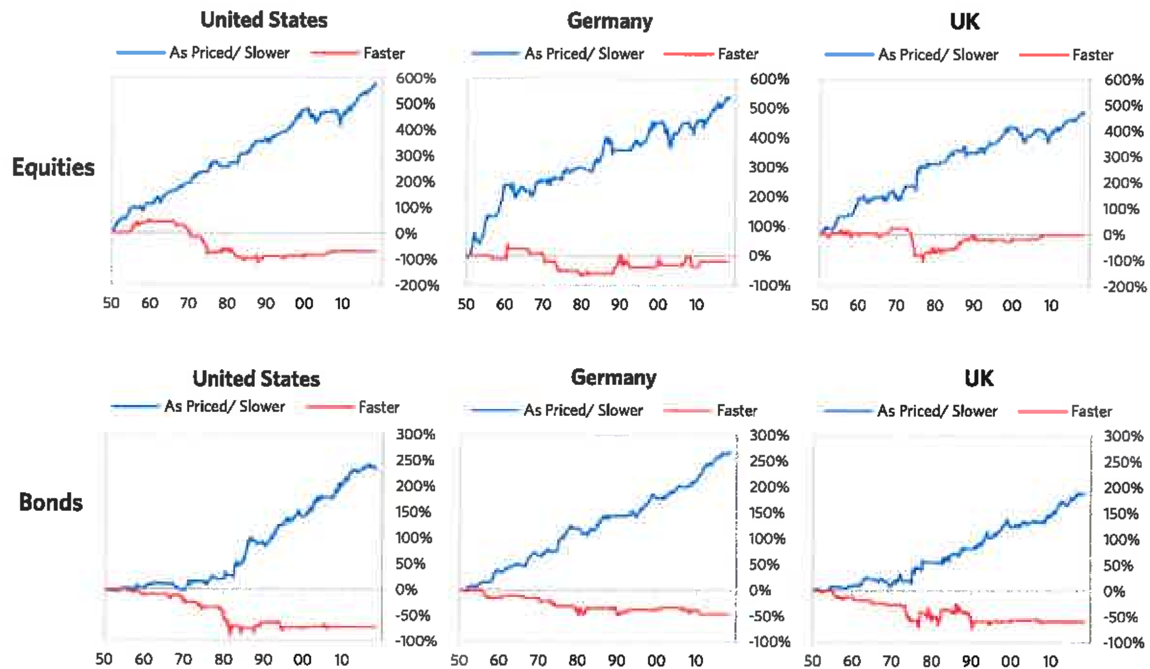
An important barometer for a movement to the next stage of the cycle is the degree of monetary tightening relative to what is discounted. Not much tightening is now discounted, so it won't take much to exceed it. As shown below, this is an important distinguishing influence on the magnitude of the effects of a monetary tightening. Cumulatively, the returns of assets are zero or negative when tightening is more than discounted, and economies perform worse.

**Asset Returns During Different Periods of Tightening Relative to What's Discounted (Cumulative Excess, ln)**



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