

As the Paradigm Shifts, Liquidity is Here to Stay

Author



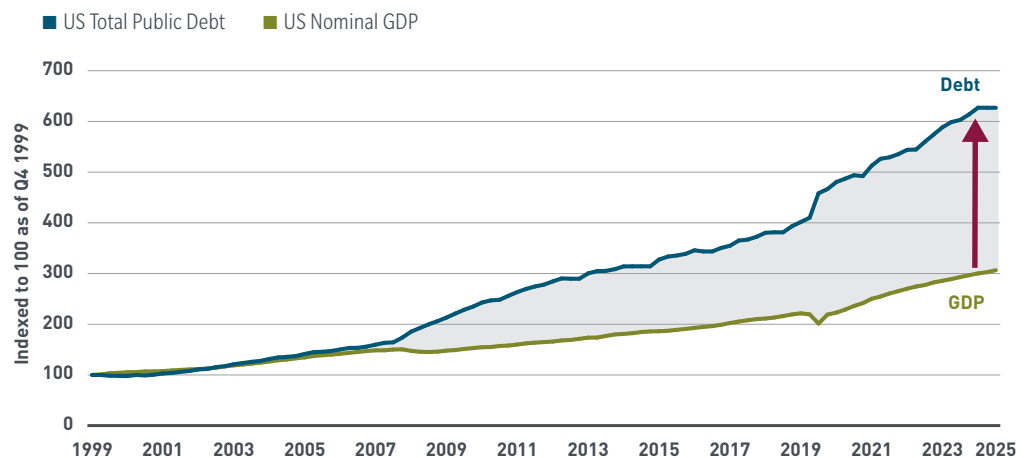
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In brief

- History teaches us that governments struggle to rein in liquidity once it's been unleashed.
- We're entering a new paradigm in which tangible fixed investment is replacing financial engineering.
- In this new environment, the disruption of profit pools may advantage active managers.

While the US government's indebtedness is no secret, investors may underappreciate its potential drag on the economy in the future. The chart below shows the growth of total US public debt compared with the size of the US economy over the past several decades. Unsurprisingly, the lines begin to diverge following the 2008 global financial crisis.

Exhibit 1: Debt to GDP has ballooned since the Global Financial Crisis



Source: Bloomberg. Quarterly data from 31 December 1999 through 30 June 2025 (latest available). Data is normalized as of 31 December 1999.

What is happening in the US is nothing new, and while history can help us think about its potential consequences, I think investors expecting a drain in liquidity to address this imbalance may be disappointed. I offer another outcome, one that isn't without costs, but one that may upend the recent and growing trend of how investors think about the price of portfolio advice.



Governments have often debased the money supply

Dating back centuries, governments have increased the money supply to fund various initiatives. This can be achieved through different methods — methods that often end up impacting the broader economy and financial markets. Two examples among the hundreds are ancient Rome and 16th century England.

Starting around 200 B.C. through 265 A.D., to fund wars, the silver content of the Roman denarius was reduced from 100% to 1%, leading to hyperinflation and contributing to the eventual decline of the Roman Empire.

Centuries later, in 16th century England, King Henry VIII ordered the precious metal content of gold and silver coins to be reduced, also to fund costly wars. Beginning in the 1540s, “The Great Debasement” replaced precious metals with cheaper copper. This led to significant inflation, damaged England’s international trade reputation and created economic turmoil that lasted for many years.

Since 2008, the US government has created money in a different way: through quantitative easing (QE). Because lowering interest rates to 5,000-year lows was not enough to stimulate economic growth, the US Federal Reserve purchased large amounts of Treasury and mortgage-backed securities in the open market. To pay for these assets, it created reserves, which increased the money supply.

However, as evidenced by the GDP line in the chart above, QE doesn’t always lead to economic growth or inflation. When money is debased, whether by diluting the percent of silver or by creating bank reserves that are not dedicated to economically productive purposes, it leads to debt imbalances.

This is important because to support this imbalance, the Fed cannot meaningfully pull back liquidity. The money supply needs to be ample relative to the debt load, and not to GDP, as commonly believed. Until the economy grows to a level that can service this debt, excess liquidity is likely here to stay in order to avoid a debt crisis.

The more likely pathway and the changes it may bring

It’s not only caesars, kings or central banks that create money. Fractional reserve banking allows commercial banks to create money, as well. In modern times, up until the financial crisis, this is how most money was created. Here’s a refresher on how it works:

When banks lend out a portion of their deposits, a loan contract is signed and a promissory note is created. That account payable is then discharged, which creates money.

For example, when a customer takes out a \$100 loan, they sign a loan contract and a promissory note, representing a promise of repayment. The bank’s assets increase by \$100 in the form of the promissory note and so do its liabilities, via accounts payable. The bank discharges its commitment by crediting the borrower’s account with the loan amount, which effectively creates a new deposit. The promissory note remains a bank asset while the liability is replaced by a deposit of \$100. This deposit represents new money in the economy that previously didn’t exist.

This system has been vital for modern economies, allowing banks to generate returns and stimulate economic growth. Of course, it stalled following the 2008 crisis, when it was needed the most. The US government’s QE programs were designed to “prime the economic pump,” but obviously didn’t produce the intended outcome, as the liquidity went instead into financial asset prices via stock buybacks, higher dividends, and mergers and acquisitions.



Since 2022, however, some of the new money has come from this private sector mechanism, funding investment in supply chain adjustments, the digital economy and, most specifically, the infrastructure for artificial intelligence. These are projects with potential economic utility, which contrasts with what, in hindsight, can be viewed largely as a wealth transfer from savers to borrowers from 2009-2021 that mostly enriched the owners of financial assets.

While circumstances can change, going forward we expect economic growth will be superior to the decade of stagnation of the 2010s. However, that will likely keep inflation and long-term borrowing costs at or around current levels.

Depending on the rate of real growth, excessive US government debt levels are likely to persist, which will make it much more difficult for policymakers to ease financial conditions in future periods of economic or market stress.

Conclusion

Government-created liquidity is a persistent feature of economies, past and present. History suggests that once increased, liquidity is hard to pull back, because leaders don't like disappointing their citizens with spending cuts. In the absence of austerity, massive central bank balance sheets need to be maintained to support excessive debt loads.

While liquidity is probably here to stay, a new capital cycle has emerged. Tangible fixed investment is rising. While it may be cut short and/or not be enough to reduce the debt burden, I believe there are three important changes entrepreneurs and investors will face that will be quite different than the 2010s.

1. While the Fed may cut short rates, long-term borrowing costs will probably anchor around present levels due to new economic activity. Specifically, I don't think we should expect 10-year Treasury yields to fall meaningfully, if at all. They could even rise.
2. The cost of running a business is, and will remain, much higher. It isn't just capital — goods are also more expensive than in the 2010s due to policy changes and economic activity. At the same time, technology has created a competitive explosion, challenging industry incumbents across multiple sectors and forcing spending on product innovation and better customer engagement.
3. We believe the combination of points one and two means that profit generation will likely become more difficult, creating greater profit dispersion within sectors and industries. Businesses with goods or services that customers need — and that can raise prices in the face of higher input costs — will thrive. Those without, however, will disappoint current lofty profit expectations, particularly without the economic safety net of artificially low interest rates and cheap labor.

Taken together, I think these factors will pull forward a new paradigm in which security selection finally matters again. ▲

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