Pepper, Gordon with Oliver, Michael J. – The Liquidity Theory of Asset Prices

John Wiley & Sons, 2006, [Finance] Grade ★★★★

Some of my smartest friends argue that the next few years will be similar to the period around 1990, where Politicians' and Central Bankers' decisions were the driving forces behind market action. Personally, I believe we are in a global deleveraging phase, a "Japan Lite", with significantly overvalued securities. Occasionally, we will see some market spikes though, due to actions from the Lords above. Either way, I felt I needed to improve my knowledge of liquidity issues to fine-tune my market timing skills. What are the best early indicators to anticipate major changes in supply/demand of liquidity? And is there a way to guesstimate the effect on market prices? There are rather few specialized books written on liquidity theory – this one was recommended to me.

The Authors – Gordon Pepper and Michael J. Oliver – are an interesting blend of deep market knowledge and academic prowess. Pepper is the joint founder of W. Greenwell & Co's UK gilt-edged business and a former Chairman of Lombard Street Research - one of the leading global Research Institutes on liquidity. Oliver is a Professor of Economics in Rennes, an acknowledged economic historian and a Director of Lombard Street.

"Liquidity" is more or less investor's jargon for what academics label Monetary Analysis, which basically is the study of supply and demand for money, credit and other flows of funds that influence the level of asset prices as a whole. Russell Napier (of *Anatomy of the Bear*-fame) says in the foreword that psychology and liquidity were the two key omissions in traditional financial education (although we have learned a lot on Behavioral Finance lately). However, most of us have a long way to go to operationalize liquidity understandings into our investment processes.

The Authors separate portfolio trades based on fundamentals from liquidity trades, where the later, like behavioral issues, sometimes move asset prices away from "efficient levels". When liquidity transactions persist in one direction for some time, it might lead to extrapolative expectations that explain some of the volatile gyrations around intrinsic values. Sometimes, as we have learned, it ends up in bubbles or busts. The current extreme experiment from our Central Bankers will be very interesting to follow.

The set-up of the book is quite conventional with five parts. The chapters on "Liquidity theory" and "Financial bubbles and debt deflation" are my favorites. Although rather short, it makes it easy to use as a reference book. There are many interesting opinions and conclusions to find. Reading the book probably improves most investors' knowledge on liquidity issues. But I don't feel the book fully lives up to the grand title and I don't see a theory that is finely chiseled, coherent and elegantly simplified enough to be practically workable in the markets themselves. Neither does it answer my stated questions. But maybe it's because they are too naïve. "*In most circumstances, the information about the behavior of the monetary aggregates that is needed to produce a reliable forecast is not available in time to make such a forecast*". My main take-away is that a solid knowledge on liquidity issues, with some number-crunching on midterm trends on aggregated data, probably helps you set the market action in perspective, pretty much like sentiment factors. However, it's doubtful if liquidity analysis is usable for fine-tuning market entries and exits.

I am impressed by the Authors knowledge and the detail in structuring these complex issues. I will certainly read their next book that may bring their theory to perfection. Currently, my favorite reading on liquidity is Ray Dalio's "*How the Economic Machine Works*". But this book is a good introduction to a fascinating topic. I still need to learn more – suggestions?

Michael Persson, December 9, 2012