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MARKET WATCH

Cash Fuels Everything

Investment Myth Busting

By Brian Thomas

(the following has been excerpted:)

Cash on the sidelines—an idea that implies money moves from one asset class to another, always in search of a home—is a myth. There are two sides to every transaction. When Investor A wakes up one day and decides to "take his money out of the market," he must find Investor B who is willing to put his in. Sure, the price of the stocks traded may move as a result, but the net amount of money put in or taken out of the market is always precisely zero.

Use of this term results in a complete misunderstanding of liquidity and its impact on asset prices. In the accepted version of reality, as money comes off the sidelines and gets put to work in the stock market, the "fuel" gets spent. Cash balances come down, liquidity gets soaked up, and the impact is significant but finite.

"When Investor A wakes up one day and decides to 'take his money out of the market,' he must find Investor B who is willing to put his in."

In truth, the cash is always on the sidelines, even after the most recent holder chucked it into the stock market like a hot potato. It cannot become something else. Someone must hold it. Any excess liquidity will continue to rapidly recycle into the market until prospective returns for stocks have been driven down to a level where the last man with the cash is happy to hold it. Such was life with QE2.