

OCTOBER 2025

36 South Views

By Richard "Jerry" Haworth

Anatomy of a Liquidity Crisis

A friend messaged me out of the blue and asked me what I thought of the markets, particularly the equity markets.

I replied that I thought the financial markets are particularly vulnerable to a liquidity crisis. The likes of which we have never seen before, because it could overwhelm central banks' ability to contain it.

Why do I believe this fragility exists?

All assets are overvalued. Some massively so. This "everything bubble" is no secret, it is hiding in plain sight. But that is only part of the fragility, only one grain at the top of the teetering sandpile.

In addition, the structure of some markets is warped by skewed inflows, making them fragile and vulnerable, should the investing herd volte face. The first global bull market where the narrowing of the leadership is in one country, i.e. the USA and within that, in ten stocks.

The structural change to passive investing has left most investors highly correlated to each other. Passive investing structures do not actively manage... they buy when the herd wants to buy (at any price) and sell when the herd wants to sell (at any price).

The bubble epicentre, AI, is distorting capital allocation in an epic way.

Another few grains on the sandpile.

Then there is illiquidity itself.

Investors have never held so little cash or near no cash. I am amazed how intolerant smart money is of even 1% cash held. Whilst Charlie Munger recommended 20% in cash always in order to be resilient, today's institutional investors ignore this wisdom.

They might get away with this if they hold a lot of liquid securities, which can be easily monetised, but there is a trend to hold illiquid securities and thus garner the premium. This leaves them particularly vulnerable to a liquidity crisis.

The poster boy for illiquid securities is private credit. Private credit is the name of the game today. It's hard to be heard at a conference above the rallying cry of private credit.

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These securities could be next to impossible to liquidate at anything close to fair value in a liquidity crisis. In addition, investors forget they don't all need to sell for the price to go down, you just need one investor to panic and sell at low prices and set the marks.

I am not an expert in private credit, but from what I read, the quality of the offerings has been steadily declining. A lot of the devil will be in the detailed fine print, I imagine, when it all goes south.

“We won't need to sell because we are long term holders”, is the common refrain. Do you not think that this is the exact reflection Japanese equity investors had in 1990? The Nikkei index took 30 years to come back to its high. Thirty years of compounding time lost, even if you did hold. Most did not.

If there is a crisis with liquidity at its heart, some investors may break ranks and the marks will be substantially lower, triggering more sell decisions, and so on and so on.

Another grain on the sandpile.

Why might the next crisis overwhelm central banks?

In short, the unregulated US dollar shadow banking system has grown too big (it is arguably bigger than the onshore banking system) and there is not enough freeboard on central banks' balance sheets, due to the high levels of debt.

Who backstops this market in a severe liquidity crisis?

Another grain...

Margin and collateral posting. Since 2008, OTC derivatives need to be margined alongside listed derivatives. This effectively doubles the notional amount of derivatives which need to be margined.

This means that in a crisis, up to a quadrillion in notional derivative exposure needs to be margined. This could result in margin calls that dwarf what is even possible, i.e. more money than is available in the economy at any point in time, thus triggering a runaway liquidity crisis.

Margining is not a multiday affair; it needs to be posted within 24 hours. If margin is not posted, the underlying exposure is put up for fire sale. This has often been the cause of a gap down market.

Another grain...

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Many modern-day investors have not seen a proper bear market that attacks, bites and slashes you to pieces. Modern day investors are like those YouTube videos of people standing up to bears and winning. You just have to hold your ground. It's at best recency bias and at worst fantasy.

With complacency as their shield, they will hold their ground and be savaged by the bear.

Another grain...

The sandpile looks fragile, and no one knows what the next grain of sand will be or when that will start it cascading. We can only observe the structure and the likely fragility of the structure.

We believe that a potential lack of liquidity in the next crisis is a very real possibility. This, in turn, means that the potential fallout could be much greater than we can even imagine.

It also means that all traditional means of protecting investments could fail, i.e. diversification, QIS, etc. All assets could correlate to one to the downside. Property, equities, bonds, commodities... bonds are a question mark, to be sure, but I wouldn't rely on them. In this kind of crisis, investors may have to sell the long end of the bond curve to get cash or near cash.

So pretty much everything except...

Cash and...

Assets whose value depends on volatility rising i.e. long volatility assets.

Most people will never hold enough cash to make a real difference, but I include it for completeness.

Long volatility assets are pretty much the only go-to in this kind of crisis, if you don't intend to hold over 50% in cash.

Why?

They have embedded asymmetrical and convex payoffs. Put down a dollar, and you may earn multiples in an event. And so, a small investment in these assets can have an asymmetrical impact on the portfolio.

Volatility is reliably negatively correlated to traditional asset prices. Volatility reliably rises when it hits the fan.

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Volatility between asset classes rises and correlates toward 1 in a systemic crisis. This means you don't necessarily need a direct hedge but can rely on a general hedge.

It is investable. The market for volatility assets is huge. Greater than 200 trillion notional in options outstanding at any one point in time.

A small investment in a volatility tail risk could make all the difference in a liquidity crisis. A kind of crisis where there is nowhere to hide... well, almost nowhere.

Disclosure

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