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Close Window

Exit: Underweight Equities, Neutral Bonds, Maximum Overweight Cash

by Liz Ann Sonders, Chief Investment Strategist, Charles Schwab & Co., Inc.
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- Schwab recommendation moved to underweight equities, neutral bonds and maximum overweight cash.
- The liquidity tide is heading out and taking nearly all speculative boats with it.
- Synchronized central bank tightenings increase risk of financial crisis/accident.
- Stock market likely to key off of weaker economic growth signals.

In another move reflecting Schwab's continued cautious outlook on the equity markets, the **Investment Strategy Council now recommends an underweight to U.S. and international equities** while continuing to avoid emerging markets. We also added to our defensive posture by **bumping both cash and bonds up a notch**—the former to maximum overweight and the latter to neutral. Within bonds, we also made two recommendation changes—moving investment grade corporates to an underweight and mortgage-backed securities to an overweight. For details behind these specific moves within the bond allocation, please see our regular weekly write-up. We remain neutral to style and cap within the U.S. equity recommendation. **We do think the market will stage a sentiment/technical-driven rebound before too long, but we'd be biased toward selling into any strength versus buying on weakness**.

Don't blame Ben

What a difference a month makes. On the eve of the last Federal Open Market Committee, the Dow was but a mere 80 points from an all-time high and emerging markets everywhere were raging. Then came the drubbing. Many market observers blame Federal Reserve Chairman Ben Bernanke, the Fed and inflation, but there's more to this decline than meets the eye.

The world has been awash in liquidity, which had built up dramatically over the past decade, driven by record low rates in Japan and near-record low rates in the United States. In Japan, interest rates were brought essentially to 0% (zero interest rate policy, or ZIRP) as the country tried to worm its way out of a decade-long bout with stagnant economic growth and deflation. In the United States, there have been multiple periods when liquidity was boosted: 1997's Asian currency crisis, 1998's Russian debt default (and the collapse of the Long Term Capital Management hedge fund), Y2K and the bursting of the Nasdaq bubble—all via successive rate cuts, with the federal funds rate ultimately bottoming at 1% in 2003/2004. As this liquidity flooded the system, it showed itself in numerous ways:

- the pain of stock market losses post-2000 was buffered by dramatically lowered interest rates.
- dramatically lower interest rates "transferred" the tech stock bubble to a real estate "bubble," keeping the consumer extraordinarily healthy.
- the tide of liquidity further lifted all speculative boats, including small- and micro-cap stocks, commodities and emerging markets.
- many of these speculative investments were fueled by the "carry trade"—borrowing on the cheap (yen) to invest in all things risky.

Global central bankers playing in their own sandboxes

Now central banks everywhere are lifting interest rates. But they continue to enact policy as if playing in their own sandboxes. With the globalization and synchronization of capital markets, the moves of individual central banks can ripple with consequential action (and reaction) across the globe as never before. Growing pains in the global financial system breed accidents…and their unintended consequences.

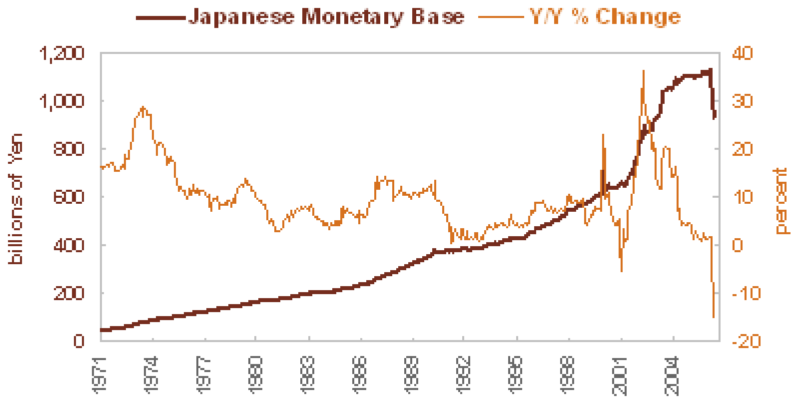
A majority of investors had been speculating that the Fed was near or at the end of its tightening campaign, a yield curve inversion (again) was not in the cards, emerging markets' fundamentals were sound, and that the dollar would continue to fall. Trades set up to capitalize on these trends are now going bad, and bad could go to worse unless these trends reverse—which is unlikely in the short term.

Here in the United States the Fed is on a likely path toward an "intentional" inversion of the yield curve, assuming the Fed hikes short-term rates at the end of this month and long-term rates remain around current levels (a yield curve inversion is when long-term rates are lower than short-term rates). As pointed out by Birinyi Associates, intentional inversions have been even more reliable predictors of recessions than market-influenced inversions. In five out of the six periods where the Fed raised rates above the prevailing 10-year yield, the economy went into a recession within 18 months, and in the other period the economy was already in a deep recession.

The picture that launched a thousand sell orders

It does seem like everything changed overnight. Well not quite, but close. If I had to pick one single visual to explain the dramatic declines in so many asset classes it would be the plunge in Japan's monetary base as seen in the chart below:

Dramatic plunge in Japan's monetary base



As of May, 2006. Source: FactSet.

This is an unprecedented plunge in liquidity from a global power player, and if there was ever a picture that could be described as "game over," this is it. Ben Bernanke's getting the blame, but I think it's somewhat misplaced. There's no question he's having a tough go at this whole transparency thing—stubbing his toe numerous times the past several weeks as he tries to send the market appropriate messages.

But what we're really beginning to suffer is the beginning of the hangover phase of the liquidity binge. It has, so far, wrung a lot of excess (very quickly) out of the most speculative trades, but it's also unleashing newfound risk-aversion that had been conspicuously absent for the last few years. In addition to the rapid withdrawal of liquidity out of Japan, there are other explanations for the severity and quickness of the sell-off:

- Hedge funds now number 9,500 and are managing $1.3 trillion…and their time horizons are often measured in minutes—not months, quarters or years like traditional institutions.
- Hedge funds have basically become leveraged pools of capital using countless derivatives and having played the carry trade aggressively.
- Cash levels within mutual funds were anemic heading into the sell-off, forcing fund managers to sell stocks to meet redemptions.
- Individual investors had previously plowed money into emerging markets and commodities, in many cases via exchange-traded funds, which allowed them to sell just as quickly.

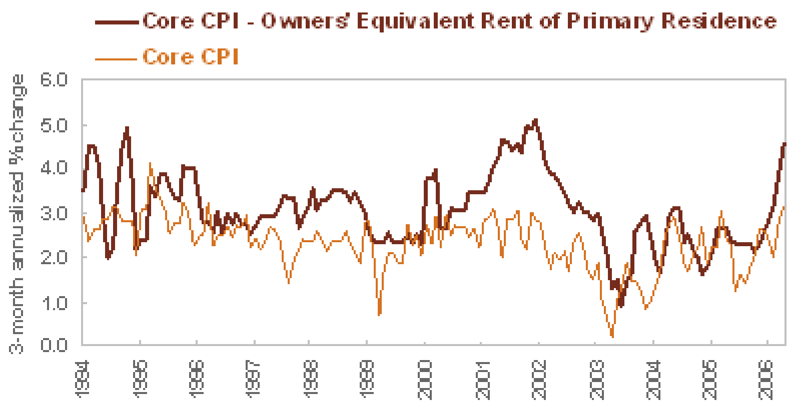
Market beginning to key off economic growth prospects

Adding to the problems associated with this liquidity drain are massive global imbalances caused by excessively easy monetary policy here in the United States; high consumption versus low savings in the United States; low consumption versus high savings in China, Japan and elsewhere; and Chinese currency inflexibility. We believe we've just entered a period likely to be characterized by sub-par growth, but with elevated inflation risks in the near term. The market, at present, is keying off inflation worries (always a problem for financial markets), but may not be anticipating the dearth of economic growth likely brewing.

Fed using the rear-view mirror

The longer-term risks of inflation are actually relatively subdued (and should remain so with a vigilant Fed), but as is typically the case, economic growth crests in advance of inflation, often leading to big policy mistakes. And there are short-term pressures on inflation, not the least of which is the rental component of the consumer price index (CPI) (rental demand is accelerating now that the purchase market is weak), which continues to accelerate as you can see in the chart below:

Rental demand hitting CPI … hard



As of April, 2006. Source: FactSet.

That said, the bond, currency and metals markets are telling us that the Fed is once again making the rear-view-mirror mistake: the 10-year yield is down from 5.2% to 5.0%; the dollar has rallied; gold is off over $100 from its high; and the basic materials stocks are in sharp retreat…not characteristics of runaway inflation. So we sit here, somewhat classically, watching economic growth descend as inflation ascends and fretting the warnings of stagflation. Bad timing for a new Fed chairman, no question. The market will likely continue to key off of every utterance from the Fed (Bernanke or otherwise) and as a result, volatility, which has returned with a vengeance, is probably here to stay for a while.

This comes at an unfortunate time. The efforts by the Fed to reign in economic growth and inflation by making money more expensive and more scarce comes at the same time the market needs prospects of high economic growth to buttress stock prices against a milieu of rising rates.

Now versus when?

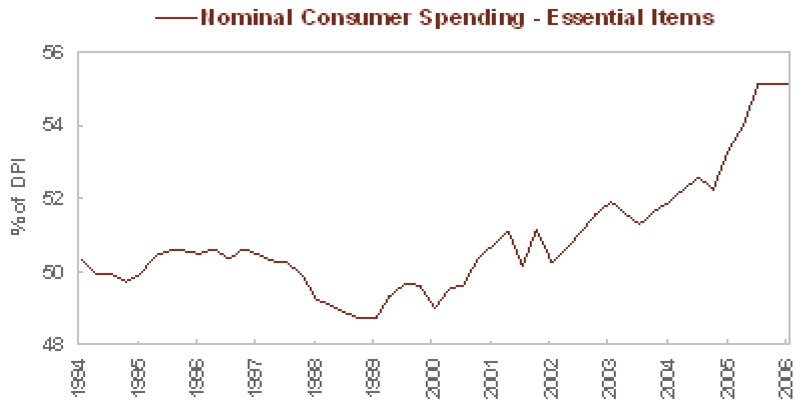
I've been asked a lot lately about comparisons between today's market environment and eras past. I've noted the similarities between this year and 1987, with a declining dollar, rising interest rates, a widening current account deficit, a fading housing boom, budding inflation, surging volatility and a new Fed chairman…but there is enough of a difference (including much lower long-term rates today) to put that comparison aside for now. Where I really see similarities is between now and the 1960s, when core inflation was mild and long-term rates were relatively low.

During the 1960s equities typically did well while the Fed was raising rates and reached their cyclical peak around the end of Fed tightening. For those who've read my past pieces, you know I've been skeptical about the end of Fed tightening being an upside catalyst for the market. As they did in the 1960s, I anticipate that stocks will begin to key more off of economic and earnings growth assumptions (both waning, in my opinion) than interest rates.

Consumers getting hit in every direction

Economic growth is set to take some hits as the year progresses. Oil prices remain high, but are no longer being offset by a strong housing market or low interest rates. Adding these weights together, household spending on non-discretionary (essential) items recently hit an all-time record:

Spending on essentials hits all-time high



Essential items include housing, other consumer debt service payments, energy, auto leases, medical care and food. DPI represents Disposable Personal Income. As of 1Q06. Source: BCA Research, FactSet.

The consumer retrenchment story is gaining traction, and signs of increased tapping of credit cards and rising mortgage foreclosure rates only add to the pressure.

Derivatives … the great unknown

So far in this report, I've written about the **fundamental** problems plaguing capital markets, but there's a more esoteric risk that keeps me up at night. The rapid growth in the use of derivatives has, ostensibly, lessened the market's risks, but the unknowns surrounding their use, correlations, associated leverage and players could exacerbate the consequences of a financial crisis.

Here's another parallel to 1987: computerized program trading had just been introduced, designed to automatically sell when certain triggers were reached. What no one anticipated was that in a crash, the computers continued to sell against one another until, essentially, they were shut down. There are now vast quantities of credit and equity derivatives with mind-numbing complexity. None have blown up…yet.

A buying opportunity coming … but not yet

The net is that liquidity is draining rapidly, with the Fed and now most other central banks stepping in. We're over three-and-a-half years into a bull market (about 75% longer than the norm since 1900) suggesting it takes an ever-increasing amount of liquidity to boost asset prices. With liquidity in retreat, caution is warranted and keeping some powder dry in cash makes a lot of sense. There is likely to develop a great buying opportunity at some point this year; we just feel there's more pain between now and then.