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Weight and see what the money stash does

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THE X FACTOR

Risk aversion has caused a rush into cash around the world

WHEN discussing the outlook for share prices, market pundits often refer to the "weight of money".

The thought is that when investors are "cashed up", they're well-placed to step up their purchases of shares and drive share prices higher; and when investors' cash balances are tight, they may have to sell shares and cause share prices to weaken.

At times in the cycle, the weight of money does have a noticeable influence on share prices. Usually, though, it's not possible to draw conclusions just from the size of the cash balances investors are holding.

It's necessary also to consider what appetite investors have to hold cash, as this varies greatly over the sharemarket cycle.

When risk aversion dominates, many investors want to build up their cash balances.

In most countries, investors are currently holding a lot of cash.

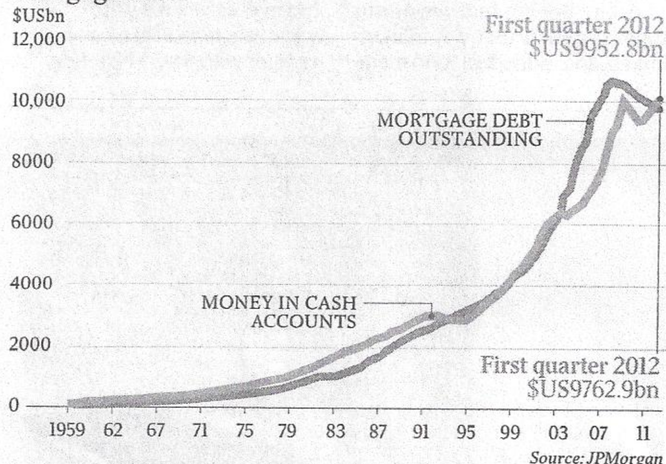
The US experience is noteworthy, because interest rates offered by banks and cash management trusts are historically low and because what happens to US shares has a powerful effect on equity markets around the world — and, particularly, on ours.

Researchers at JPMorgan Asset Management have recently pointed out that cash accounts of US investors have been increasing at a "remarkable" rate and this is "despite historically low interest rates and negative real yields".

These cash balances in the US now stand at $US10 trillion ($9.7 trillion) and exceed the total mortgage debt of American households.

Their conclusion, though cautiously worded, is good advice: "Investors need to recognise that as nervousness subsides and cash is deployed, it could translate into higher (price/earnings) ratios and equity market gains. Additionally, this dynamic is symptomatic of the need to help investors understand the implications of negative real returns, as the $US10 trillion sitting in cash accounts earning negative real interest rates is a gross misallocation of resources."

US investors are cashed up: cash accounts exceed mortgage debt



Source: JPMorgan

Australian investors are also hoarding cash. Money at call and term deposits now makes up almost 30 per cent of household net wealth compared with a long-term average of 23 per cent.

Self-managed superannuation funds also hold about 30 per cent of their assets in a highly liquid form. Like their American counterparts, Australian businesses are, on aggregate, strongly cashed up.

Of course, with local interest rates at fairly attractive levels relative to inflation, investors are earning comfortable returns on their cash holdings.

I can suggest three, though inter-related, reasons why investors are heavily cashed up.

First, the global financial crisis and its aftermath have greatly reduced investors' willingness to take risks; their emphasis is on capital preservation, even if, as in the US, this involves receiving an interest return less than inflation.

Second, in Australia there has been a lot of discussion about whether "balanced funds" should reduce their traditionally high allocations (often about 55 per cent of assets) to shares and increase their holdings of fixed-interest securities.

Some fund managers are in the process of lifting their strategic allocations to cash, deposits and bonds.

Australian businesses are, on aggregate, strongly cashed up

Third, recurring fears that the European sovereign debt crisis will hurt the US economy have discouraged American investors from switching out of their high levels of cash and into shares, notwithstanding the historically low interest rates and the strong recovery in corporate profits in that country.

As a US commentator expressed it recently: "People focus so much on potential macro pain that they don't appreciate the gains that good companies have made, and that things are slowly getting better."

History tells us that weight of money considerations do not contribute much to the beginnings of upswings in sharemarkets from their cyclical low points.

The weight of money — and its twin, the weight of borrowing — usually come into their own at a later phase in the sharemarket cycle, as investors become more risk-tolerant.

This adds momentum to the upswing and, subsequently, can help push the sharemarket to sustainable levels.

That is the average experience over many cycles.

Perhaps, this time, the weight of money in the US — with its historically low interest rates and exceptionally high cash balances — could have an early and more powerful effect on that country's sharemarkets.

Watch that space.

Don Stammer is an adviser to Third Link Growth Fund and Altius Asset Management. The views expressed are his alone.