Liz Ann Sonders: Don't Fear a Recession or Market Overvaluation

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by Robert Huebscher

This article is part of our Schwab IMPACT 2016 Special Coverage this week. More articles are listed below.

A recession is not imminent and investors should be skeptical of those who claim the market is vastly overvalued, according to Liz Ann Sonders.

Sonders is a senior vice president and chief investment strategist for Charles Schwab & Co., Inc. She was one of the opening night keynote speakers at this year's Schwab IMPACT Conference, held in San Diego.

Approximately 2,000 advisors were registered to attend the conference, the largest in the industry.

Sonders cited a famous quote by Sir John Templeton, "Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria."

She offered her own version: "This bull market was born on despair, grew on disbelief, is maturing on skepticism and may die on acceptance."

According to Sonders, the bull market is still maturing and the prospects for capital growth are intact.

Sonders acknowledged that a recession is a key risk that could trigger a downward move in stock prices, but she said that a recession is unlikely and that the most likely scenario is that the economy will "muddle through" in 2017.

I'll review Sonders' comments on the economy and some of the other risks she foresees.

Monetary policy-driven risks

Sonders said that market volatility has been driven by central bank policies – particularly those of the Fed. There is a growing acceptance, she said, that markets and economies will face some of the side effects of zero interest rates and quantitative easing.

She identified some of the perils of unprecedented monetary policy: depressed interest income, yield chasing, unhealthy companies being propped up, and healthy companies buying back their stock and not investing in capital expenditures.

She said the most important consequence is asset-price inflation: equity and fixed income asset classes are up 25% to 250% versus "real economy" price increases, which have been far smaller. This has led to a "massive spread" between the benefits to investors and the real economy, Sonders said, and has fueled debate over income inequality.

Another consequence is that household net worth has grown faster than nominal GDP during the post-crisis period. The gap between the two is similar to 2007, and according to Sonders "this is a macro risk."

She added that "the Fed has limited its power in case of trouble" by keeping interest rates so low. She said this leaves it in a position where it must resort to quantitative easing if an economic contraction occurs.

Where are we in the cycle?

Is a recession on the horizon? "We don't think so," Sonders said, "but the risks have risen mildly."

Sonders provided data on a number of leading-economic indicators (LEIs), which she said have not "rolled over." A recession would be “unprecedented” if it were to happen under current circumstances, she said. The only LEI that is worsening is the average workweek, and Sonders downplayed its significance.

She said she follows a recession model by Cornerstone Macro and its shows a 36% risk of recession –“not yet flashing a warning,” according to Sonders.

Inflation is picking up, she said. The core PCE and CPI indicators are 1.7% and 2.3%, respectively. The difference between the two is in housing and health-care inflation, which are rising faster and have a larger representation in the CPI than the PCE.

“We are starting to see upward pressure on wages,” Sonders said, but this could be a statistical mirage. Sonders noted that average hourly earnings went up during the last recession. The problem is that it is an average of everybody, and those who lost jobs were on the low end of the wage spectrum. The opposite has been happening during the last several years – the economy is adding low-paying jobs. To resolve this, she said the Atlanta Fed came up with a “wage tracker,” which is similar to same-store sales concept in retail. It is up 3.5%, she said.

Real median household incomes have had the biggest jump (5.2%) in history, she said. They are not yet back to their prior high, but the biggest gains were in the lowest deciles of income earners.

The election

Sonders provided some historical factoids on elections and market outcomes.

Open presidential elections (without an incumbent) have correlated with poor market performance. The market does better when an incumbent party wins, she said. In the 90 days leading up to the election, a higher electoral victory correlates with better market performance. In the betting markets, the likelihood of a Clinton victory is at 80% and Trump is at 20%. The equity market has had a 90% correlation with the odds of Clinton winning.

“The least unsettling outcome would be a Clinton win and the House remaining in Republican control, if not the Senate as well,” she said.

“The market does better when government is divided,” Sonders said. But, she said, the political gridlock is holding back capex. She also said that when Fed moves quickly in rate-setting, the market is generally flat. When it moves more slowly, it leads to “significantly better” outcomes for the market.

Sonders views rate hikes as a positive. She said that, for the typical household, the ratio of interest-rate-sensitive income to expenses is approximately 4-to-1. Thus, the benefits of a rate increase outweigh the costs four-fold for the typical U.S. household.

“Valuation metrics can support any view of the market,” she said. The metrics that are dependent on an inflation or interest-rate component show that the market is cheap, she said. But metrics such as the forward P/E ratio show a median valuation. Sonders said that valuations tend to be highest when inflation is 2-3%, just above its current range. “But inflation going higher is a risk for P/E ratios,” she explained.

“Economic recessions are always accompanied by earnings recessions,” Sonders said. They are generally triggered by a crash in oil prices and a rise in the dollar. She said we are “clawing out” of an earnings recession with a “lessening drag” from the energy sector. “If we don’t get capex up, it is a risk,” she cautioned, “especially without stock buybacks.”

Sonders noted that mutual funds have had net redemptions since 2008, while the ETF market has grown. Overall, she said, not a “single dollar of net new money has been added to the U.S. equity market since 2007. That tells me the wall of worry is still very much intact.”

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