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Piles of Cash on the Sidelines

Bullish sign or a load of bull?

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How much cash is sitting on the sidelines? And more important, does it really matter?

When investors are looking for reasons to be bullish about the stock market, they like to point to the huge amounts of money parked in Treasury bills, money market funds and other short-term securities.

Presumably, when the gloom pervading stock markets lifts, this money will come rushing back into equities, touching off a powerful rise in prices. At least that's the theory.

If only the real world were so simple.

There's no denying that investors have lost their stomach for stocks and are showing a clear preference for less risky investments. According to the Investment Funds Institute of Canada (IFIC), Canadians had parked $72.3-billion in money market funds as of January, up 24.2 per cent from the same month a year earlier.

That's just a portion of the money sitting in short-term, highly liquid investments. If you add cash balances in brokerage accounts and in money market funds at non-IFIC members, the amount of cash or near-cash investments could easily reach $200-billion, says independent analyst Peter Loach. He admits that's a guesstimate. "Only Kreskin would have that number," he says.

And it says nothing of the nearly $900-billion more that Canadians have in savings and chequing accounts and term deposits at financial institutions.

If you want some truly eye-popping numbers, look south.

In the United States, there was about $8.85-trillion (U.S.) sitting in cash, bank deposits and money market funds at the end of 2008. That was equal to 74 per cent of the market value of all publicly traded companies - the highest ratio since 1990, according to a Bloomberg report.

The report went on to say that when the amount of cash relative to stock prices reaches extremely high levels, the market often rebounds forcefully.

In 1974, for example, cash reached a record 120 per cent of U.S. stock market capitalization. Over the next six months, stocks rose 31 per cent. In 1982, with the ratio at 95 per cent, the S&P 500 posted a six-month gain of 36 per cent. And in the recession of 1990, the ratio reached 75 per cent and stocks jumped nearly 30 per cent in the following year.

Will we experience a similar rally this time? Not necessarily. For one thing, the fact that the ratio of cash to stock market capitalization has risen shouldn't surprise anyone. After all, the U.S. stock market has been cut in half in the past 12 months, so even if we assume Americans haven't added a penny of new savings, the ratio of cash to stock prices will have doubled.

We should also keep in mind that many baby boomers are a) retiring and b) traumatized by the market's collapse, both of which suggest that they may stick to conservative investments longer than in previous downturns, if they ever develop an appetite for equities again.

"They're not necessarily keeping their powder dry for opportunities, they're just trying to preserve what they have left. I think that's pretty clear," Mr. Loach says.

What's more, as UBS strategist George Vasic points out, cash in money market funds is a lagging indicator of stock market performance. In other words, most investors start deploying cash only after the market has turned higher, reflecting improving fundamentals.

"What will end up happening is that the market will rise first as confidence returns and presumably the bleakest scenarios are eliminated, and then after that you will see the fund flows roll into the equity market, and that will then reinforce the trend," he says.

Bottom line: Just because investors are sitting on a lot of cash doesn't mean the stock market is going to rise.