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Why Investor Positioning Matters More Than Ever (With Eric Liu)

COLLIN MARTIN: I'm Collin Martin.

LIZ ANN SONDEERS: And I'm Liz Ann Sonders.

COLLIN: And this is *On Investing*, an original podcast from Charles Schwab. Every week we analyze what's happening in the markets and discuss how it might affect your investments.

LIZ ANN: Well, hi, Collin. So we've talked a lot about your world and bonds the last few weeks, but one thing that's back in the news this week, which we haven't talked about in some time, is the yield curve. So maybe let's start with a reminder to listeners what the Treasury yield curve is and why it is making headlines recently.

COLLIN: Yeah, that's a great place to start, Liz Ann. The Treasury yield curve is a line that connects the dots between the yields offered on Treasuries of various maturities. So if I can kind of paint a visual here, you know, you start with a three-month Treasury bill, and as you move from left to right, you see what slightly longer-term Treasury yields are. So moving from a three-month Treasury to, say, a 12-month to a two-year Treasury, 5, 10, all the way to 30 years.

When you connect the dots with the line, that is the yield curve. So the yield curve can be positively sloped, meaning we can earn higher yields with long-term bonds than we can relative to short-term bonds. It can be flat, meaning yields are all pretty similar from short to long, or it can be inverted, meaning short-term yields offer higher yields than long-term bonds, which I think is a tricky thing for a lot of investors to kind of wrap their head around. Because if you're an investor and you can get, I'll use round numbers here, not necessarily indicative of the environment we're in right now, but if you can get, say, 5% on a T-bill and 4% on a 10-year Treasury yield, you know, why would we want to lend for 10 years at a lower yield than what I can get in in a short-term Treasury bill? And there there's a lot of factors that would go into that decision in terms of the outlook for growth and inflation, the general direction of interest rates, and what the Fed may or may not do.

Now, on the idea of the slope of the yield curve, there's a few reasons why the slope can change, meaning why it can steepen, where the difference between long-term yields and short-term yields increases, or why it can flatten, meaning that gap shrinks a little bit because it can be driven by both aspects. It can be driven by moves in the short end or the long end. And I think we're getting headlines about this recently is because it has flattened a little bit recently. Although over the past few days it's ... some of that has been reversed, but it's flattened, where short-term yields have risen more than long-term yields. So even if they're both moving in the same direction, if short-term yields move higher, that closes the gap a little bit. So right now, you know, a key part of the yield curve that we look at and a lot you might see headlines about is the difference between two- and 10-year Treasuries. And that difference right now is around 40 basis points, or 0.4%.

Now I mentioned that the yield curve can invert. And that could be what's grabbing some headlines lately, Liz Ann, because when the yield curve inverts, again, when long-term yields are lower than short-term yields, there can be negative connotations there. Because historically, recessions have generally been preceded by an inverted yield curve. Now there's a good saying out there, I don't have the exact numbers, maybe you have it, Liz Ann, but it's a joke like "The yield curve has predicted 15 of the last nine recessions," or something like that.

LIZ ANN: Yeah, yeah.

COLLIN: Throw in whatever number you want to put in there, but it's not always right. So all recessions have been preceded by inverted yield curves, but inverted yield curve has not always been followed by a recession. And a good example of that was somewhat recently. So basically from 2022 through 2024, the yield curve was inverted for a large number of that time frame, and the recession that a lot of people were expecting never came. So we use it as this as a signal, but it's never a guarantee about what's to come.

LIZ ANN: You know, and Collin, let's talk about what's going on in the bond market in the context of the inflation data that, as you and I are taping this, we just got released today, which is the Personal Consumption Expenditures index. That is the ... still the Fed's preferred measure. In fact, Fed Chair Kevin Warsh confirmed that that was still the preferred measure. So it came in a bit benign relative to expectations, meaning better than expectations, not as big a jump. The only rub being that there were methodological changes to the construction of that index. And that explained a good chunk of that more benign reading. And in fact the core services, ex-housing, which is a component or a derivative of the PCE that the Fed also pays close attention to, that's still running relatively hot at about, I think, 3.4,

3.5%. So what were your takeaways from the release? And then and then let's talk a little bit about the update to second quarter GDP as well.

COLLIN: Yeah. So you know, the my initial take on this morning's PCE release was that it was pretty good, and pretty good meaning we want, you know, slightly lower numbers, softer numbers, so that that doesn't necessarily mean the Fed would need to hike aggressively to bring inflation down. And since the Fed hiked a few weeks ago, you know, PCE has kind of been on our radar about something we're going to be looking at, two things we're going to be looking at, that we think can help drive the Fed's decision making over the next few months and quarters.

The first is the monthly changes in the core PCE reading, because that's something that New York Fed president John Williams has specifically singled out, where he said he'd like to see monthly core PCE ratings, readings at 0.2% or less to kind of give them confidence that inflation's moving down towards the Fed's 2% target. And we got that with this most in most recent release. It came in at 0.2% for the month of August. Now rounding matters.

LIZ ANN: Yeah. Zero, yeah, 0.247%.

COLLIN: Hey, we'll count it.

LIZ ANN: So if we had had three one hundredths more, it would have been that 0.3, I know.

COLLIN: You know, and there's funny ways you can show it where you can look at charts that just show the rounded number, right? Was it 0.2 or 0.3%? Or you could look at the unrounded. If you look at the unrounded, it's right in the middle. But hey, for the ... and what we're looking for right now, we're going to count that for. We'll chalk that up in the John Williams column. But equally as important, the last month was revised down to 0.1% from 0.2%. So we've had three straight months where core PCE has come in at or below the threshold that John Williams has suggested. And if we look at the three-month annualized change in the core PCE, it's now down to just over 2%. Now, three months, it's a step in the right direction. We need to see that continue, but it's certainly good news.

What we're also looking at, though, is not just that that one number, but we know that Kevin Warsh has been talking about the breadth of inflation. And when we look under the surface of these inflation indicators, how many of those subcomponents are rising at, you know, rates that are just too high? So he singled out the percent of components rising at 3% or more on a year-over-year basis. And we got some good news there, as well, in August where it actually came in a little bit better than July. Only a little bit, but it shows that things weren't necessarily broadening out. So I'd

say these were two good things if you're a Fed voter right now that you can point to say "We can be patient here." So we saw expectations of a hike in October come down a little bit after this release. It looks like there's still an implied probability of a hike by December, but expectations for October came down a little bit. And I think this just gives Fed officials a little bit of time to kind of see how the next month or two plays out before they might feel the need to hike again.

LIZ ANN: Yeah, and we also got the latest estimate for second-quarter GDP. It's the third estimate. There won't be another final estimate for a while, but you did see an upgrade. Overall GDP, the second estimate a month or so ago, was 1.5%, and it was revised up to 2.2%, and the key consumer spending component, which represents close to 69% of GDP, that was revised up from I think it was 3.5%, or no, maybe even 3.2% to now 3.8%.

And interestingly, fixed investment was revised higher. Now that has two components to it: residential, which is obviously housing, and non-residential, which is basically business capital spending. Both of those were revised a bit higher. One thing I wanted to point out, though, there were no revisions to imports and exports in terms of the growth rate. The growth rate is still much stronger for imports, 12.6% versus 5% growth rate for exports. But a lot of those imports are associated with the non-residential investment boom, because the build out of AI, which is a big component of that business capital spending, obviously, a lot of what has to be purchased are imports.

Now, the interesting thing about that is that because we import more than we export in the United States, if you look at all of the contributors and components to GDP, trade actually represents -4.5% of GDP because strong imports, if they're not offset by even stronger exports on a weighted basis, acts as a drag. So here we have this boom in business capital spending, yet then the trade line item that goes into GDP actually was a -1.1% rate. So that's just the ... an important thing to note. You have this boom in the U.S. capital spending cycle, but from a trade perspective, there's actually a minor offset in terms of drag because so much of what is needed to build out the infrastructure for AI comes via imports.

COLLIN: I want to follow up on that, Liz Ann. So you were using the term boom. So how do we kind of square this? Where inflation, we've gotten some good releases and, you know, we want to see inflation come down. Yet if we're seeing activity, you know, boom, and we're seeing personal consumption pick up like it did, how do we square those two?

LIZ ANN: Well, what I worry about, and I think it's because, at least at the headline level, the drag from energy has been pretty persistent, obviously, but it's starting to

wane in part just because of base effects. What I worry about, Collin, is that a component of energy, and associated with the war and the closure of the Strait of Hormuz, is the rocket ship that diesel prices have been on. And everything pretty much on the goods side of the economy is transported in some form or another. And unfortunately the ripple effects associated with the spike in diesel prices has not yet fully worked into some of these inflation numbers. So that is one thing I worry about. Absent a quick resolution to the war and the supply/demand forces start to get more a little bit more balanced. So that that's what I worry about on a going forward basis.

It doesn't surprise me that the other feeders from the increase in oil prices start to fade because if oil prices are, in the case of Brent crude, just bouncing around \$100 for a while now, then the base effects start to work in in favor of not being additive to inflation. But so far, I would say also AI is more on the inflation side, not the disinflation side. I'm a big believer, I don't know about you, that AI is probably in the medium-to-longer term has got some pretty significant disinflationary forces, but there are also inflationary forces in the near term, not least being the fact that a lot of what we are importing in the buildout of AI is running hot in terms of both growth and inflation.

COLLIN: Yeah, I totally agree there. I think over the long run it can be disinflationary. But what we're seeing with just the huge boom in investment, it's hard to see how it can continue to be somewhat of an upside risk to inflation, just given that activity just ... we hear new headlines every day about new projects. I know there's a lot of concerns around potential projects starting, but there's a lot going on there.

If we can move a little bit just to the equity market because I talked about the bond market a little bit and we looked at how we got some good revisions to growth in the second quarter. How are equities kind of reacting to all this? We have on the one hand yields are rising, which in a vacuum can be a negative for equities, but on the other side, strong economic activities should be good for equities. So what's going on there?

LIZ ANN: Well, I think you have to open the hood a little bit and not just think of equities in the context of just the, what the index of the S&P 500® is doing, which of course is cap weighted. And because most of the strength recently has been back in the mega-cap tech names of kind of the AI theme, that keeps the cap-weighted index in relatively healthy territory. But under the hood you do see the impact of a higher-yield environment. So on a month-to-date basis, which is only this day as we're recording this left in the month of September. But you know, you've got the classic late cyclical like materials and financials to some degree, those are down a lot.

utilities and real estate, very interest sensitive. You see it you see it even at a more granular level in the underperformance of the non-profitable small cap stocks versus the profitable small cap stocks, the underperformance of the zombie companies, the companies that are at the mercy of interest rates as it relates to being able to fund ongoing operations via debt.

So I think there is a story that can be told in terms of the impact on, and only you can see me, you know, air quotes the market. It does require, I'll use another metaphor here, it does require peeling at least a layer or two of the onion back to see where the hit is. In general, there is still an inverse correlation between bond yields and stock prices in this environment. But as I ... you'll hear in the conversation that I have with our guest, that it's been a little bit asymmetric. So inverse correlation broadly, but when yields have been rising, that's it has more of a negative impact on stocks than when yields are falling. It has a more positive impact on stocks. So it's a little bit asymmetric. A bigger inverse correlation when yields are rising, a little bit less of an inverse correlation when yields are falling.

COLLIN: And we're starting to see some cracks form. You mentioned zombie companies, and maybe not specifically for zombie companies in my world, but the broad high-yield bond market, we are starting to see some cracks because that's an area where higher borrowing costs can really start to have an impact. So high-yield bonds are issued by sub-investment-grade rated corporations. So high-yield bonds are just those that have sub-investment-grade credit ratings, also known as junk ratings. They're rated BB or below. And we're finally starting to see some cracks just over the past week or so where spreads, which is the extra yield that a corporate bond offers relative to a Treasury of similar maturity. We're seeing those spreads increase, which is a sign of investors kind of taking a look at the outlook, the marketplace, and saying, "You know, I think I need a little bit more yield to compensate me for the risks here of lending to these companies."

But we're seeing the moves and spreads hit the lowest rated bonds the most. So within the high yield bond market, we can kind of break it out into three main credit ratings: BB, which is the highest tier of the junk spectrum, B, and then CCCs. Triple C spreads have been rising for most of the year, but that kind of accelerated recently, which makes sense because those are the most indebted companies. So when borrowing costs are rising just in general, that means they likely need to be refinancing at higher yields, which poses a risk because they have a lot of debt, high interest expenses, and usually very thin margins, very little wiggle room with their cash flows. So we're seeing that impact them the most.

We're starting to see it impact a little bit, the BB's and B's, but so far spreads have been pretty well behaved. We're seeing most of the movement in CCC-rated

companies. So that's something that we're going to be paying attention to over the next few weeks and months to see, you know, how broad of an impact is the rise in Treasury yields having on the various parts of the market.

And Liz Ann, you mentioned before a guest. So we do have a guest this week, so can you give us a little overview of the interview?

LIZ ANN: Sure. So our guest is Eric Liu. He is the co-founder and head of equities at Vanda. It is a financial data analytics and insights firm specializing in investor positioning and tactical macro analysis. I've been a recipient of the research for some time, and it's really fascinating. Prior to co-founding Vanda, Eric conducted macro and equity research at Wellington Management, Balyasny Asset management and Morgan Stanley. We had a great conversation. I had the chance to ask Eric about his firm's work on positioning and also emerging markets, or EM, and a lot of other things.

And I wanted to just add a little note in here for the uninitiated. Anytime you hear a market analyst or an institutional investor talk about "positioning," they're referring to the financial exposure that those portfolios have in the market, different segments of the market—whether they're on the long side, whether they're on the short side, in terms of, in particular, equity exposure. And essentially it references whether they are expressing a bullish view via positioning or a bearish view based on positioning. But I really hope that everybody enjoys the conversation with Eric as much as I did.

So Eric, thanks so much for joining us. I've been looking forward to this conversation.

ERIC LIU: Thanks for having me, Liz Ann. I'm a big fan.

LIZ ANN: Thanks, right back at you. So let's start with a little bit of a just a history of Vanda. I know you're one of the co-founders and the genesis of that and then maybe the way you approach markets in a relatively unique process around positioning. So it's a very open-ended question, but let's start there with the genesis of Vanda.

ERIC: Sure. So we've been running this company for a while. Now we started the firm back in 2012. And when we started the company, I think what we realized was there was just this lack of really good insight and data around kind of a tactical time frame. So we're looking usually at markets in two-to-three-month time horizon. And so when we started going down that route, I think a couple of things were clear. And that really gets to your point around our focus around positioning and flow and things like that.

The first was that, you know, we're all students of economics. In any other good or service in the world, when we think about pricing of an economic good or a service, we think about supply and demand. But no one thinks about that in the equity market or the fixed income market, right? We tend to talk about fair value or valuations and things like that. And so we wanted to really tackle this angle of what if we looked at assets and markets in the same way that that we would look at any other any other good or service. So thinking about the world in terms of supply and demand, how much equity supply is coming out, more importantly how much demand is coming in, how is that changing and how have those dynamics changed over time? And so that's something that we spend a lot of time thinking about is where's the demand for stocks coming from? Where do we think it's going to go in the near term and what do we think is kind of driving that demand up or down, and so that's one part of it.

And then the second part of it, which is really this idea of trying to be really intellectually honest about what we can and can't do. And I'm not sure if you're familiar with the Good Judgment Project. So the Good Judgment Project at the University of Pennsylvania, they of course had that great book, *Superforecasters*. They did this great study in the mid-2010s. And what they did is they tested all the superforecasters and they said, "Let's try making predictions about the weather, about markets, about geopolitics on different time horizons, on the one-month horizon, a 3-month horizon, a 6-month, a 12-month horizon." And it turns out that when people make predictions beyond 90 days, which is three months, their ability to forecast degrades significantly, right?

And so I think if you're really being intellectually honest about what is possible, what you can actually forecast, I think looking at the world in these two-to-three-month chunks to me makes a lot more sense than trying to think about how the world's going to change in 10 years, which is incredibly hard, especially nowadays. So I think it's those two elements of thinking about the world in this tactical sense, but also incorporating a lot of work around positioning, flow, a lot of data and analytics around that stuff as well that really sets us apart.

LIZ ANN: All right, talk about cohorts that you are tracking and, Eric, also how you how and where you get the data to do the work you do.

ERIC: Sure. Yeah, so I think, you know, that's changed a lot over time, right? So when we started the company, you know, over 10 years ago, the big players in the markets were hedge funds and they were the big, big mutual funds, right? And these two cohorts were, you know, 50, 60, 65% of daily volume in any given time, if you exclude market makers. That has changed pretty dramatically, as I'm sure you and your entire audience knows very well here.

You know, throughout the 2010s you saw this gradual increase in quantitative investing. So quant funds were 20% of the market volume, again, all ex-market maker, back in 2010. That is now 35%. So by quant funds I'm including systematic funds like CTAs, risk parity, things like that.

LIZ ANN: CTAs being commodity trading advisors.

ERIC: Correct, commodity trading advisors, exactly. Commodity trading advisors who, you know ... the history of them is they have historically been big traders in commodity futures. But now they trade all assets in futures, but they tend to be very momentum driven. This is kind of momentum model driven investing, and so we saw the big rise of that throughout the 2010s, and that continues to be a really big part of the market today.

And then of course in 2019, retail investors become much, much more prominent, right? And so there's a couple of factors behind that. Obviously one of them, which you know Charles Schwab was a big part of as well, was reducing commissions down to zero. And that brought a large number of individual investors into sort of trading on a regular basis. The rise of really popular stocks like Tesla. Like Tesla was used to be the big meme stock in 2019, if you can believe it or not. And then you know the ultimate big bang, which was Covid, right? And so what we saw from retail investors was again, you know, prior to 2018, 2019, retail investors might have been 25% of market volumes, again, excluding market makers. And then that really exploded during Covid and we reached up to 40% of market volumes during some quarters. And right now we're kind of sitting between 35% and 40%.

So all of which is to say, you know, if you were to look at the market from a cohort perspective and from a broader perspective, in a really fixed way, that would not be possible, right? Because you would still be focusing on a lot of your attention on trying to understand where the hedge fund community is and where the long only community is. Whereas in reality, nowadays 70% of volumes are being driven by these quant and systematic funds as well as retail investors. So it really behooves you to spend some time focusing on what these folks are doing.

LIZ ANN: And where are you getting the data on all of these cohorts? How are you tracking it specifically?

ERIC: Well, Liz Ann, a lot of that is part of our secret sauce here at Vanda. We ... I'll put it this way, we ingest a ton of data. We ingest a ton of data. And in fact, we're just now launching our new Vanda analytics platform which houses, you know, thousands of these data sets in one place. And so what we do is we ingest a ton of data. We've now been doing this, I think we've been, you know, we've been looking

at this stuff for frankly, I think longer than anyone in the market and so we build our models around the academic work, we build our models around our own proprietary internal research, we build our models around what we've seen has worked in in the past, and we're constantly reality checking that that these things make sense against sort of reference indices.

So to answer your question, we just use a lot of data. And I think that we have probably some of the most sophisticated models in terms of the folks who are trying to do this on the street.

LIZ ANN: Eric, you mentioned retail investors, obviously, our bread and butter. Do you look broadly at the retail investor community or do you parse out what would be maybe slightly differently described as the retail trader? You know, at Schwab obviously we have a ... we've run the gamut in terms of our individual investors, whether they're long-term, advice-driven investors versus shorter-term traders. So do you do that differentiation or are you looking at sort of the aggregate pool?

ERIC: We're a bit agnostic in terms of where the intention is. What I'll say is, you know, we're taking sort of intraday flows, right? So we track retail activity on a 15-minute basis. So actually, you know, right now we're recording this at about 10:15 a.m. East Coast time. I can tell you what retail investors did 15 minutes ago at the open. So we track that flow regularly. What we've seen, though, is in kind of a roundabout way of answering your question, Liz Ann, is we had a lot of activity at the start of Covid in single stocks. And this is a good way of kind of thinking about it. About 70% of the flow coming through our systems was single-stock activity. So people buying individual names in 2020. So stuff that people would generally think of as being slightly riskier. That has changed significantly.

And so that 70% nowadays is closer to 30%. And with the remainder being exchange traded funds, ETFs, right? And so I think there's a couple of things happening here. But most prominently is this notion that you know the average new entrant into the market back in 2020 was, you know, someone typically in their kind of early 30s, late 20s, right? That cohort has obviously matured over the last five or six years. And as they've matured, they've taken the same journey that I think a lot of us have taken as investors or individual investors, which is we spend a lot more time thinking about exchange traded funds, ETFs, and other products in terms of investing.

LIZ ANN: Are you doing any work on the betting markets, the prediction markets, and the what this is something that has ... we care deeply about and we've tried to be kind of booming voices on the subject of what has been the blurring of the lines between investing and gambling, especially as you go down into the younger

generations that view gambling in whatever form as something equivalent to investing, and didn't know whether that was something that you were going to start to or maybe already have started to work on.

ERIC: Yeah, absolutely. I think if anything we've been forced to do work on the betting markets because of, frankly, the underdiscussed impact it's having on some of the activity from retail investors in typical kind of trading venues in equities. So I'll give you, you know, one anecdote which is really, I think, telling. If you remember, toward the fall of last year, crypto kind of peaked and it started to roll over, right?

You look at our data on single-stock activity and single-stock purchases by retail investors. It had a very similar trajectory, peaking in October, November, and then very rapidly declining into this year. And if you look at a chart of the single-stock activity and crypto activity look very, very similar, having peaked last fall. Now, what other chart looks like that? The other chart that looks like that is betting activity at Kalshi and Polymarket, which really started taking off last fall, roughly when kind of the college and in NFL college football and NFL season started, and has really been up and to the right since then.

So you see a very strong inverse correlation between the activity in retail markets and the fate of crypto markets and this rise of betting markets. So I think you know, a year or two ago you would have said, you know, what's the risk that you're going to see some cannibalization here or from a retail perspective? I wouldn't have been as worried, but I think in the data now you have to respect the fact that you are seeing a share shift happening. And you know, I think that leaves for interpretation what that means for traditional public equity markets and given what I just said about the importance of retail investors in the cohort, what that means for you know for the bid for equities.

LIZ ANN: So I want to mention a report that you put out earlier in the week turning newly bullish, I guess bullish on equities for the first time since May when you went from bullish to neutral, correct?

ERIC: That's correct, from bullish to neutral.

LIZ ANN: Right. And now from neutral to bullish. So what led to that turn, especially given some of the weakness we're seeing very recently? What was the trigger?

ERIC: There were a couple of things factors behind that. And I think, you know, for me the most important factor has been the emergence of what seems like an asymmetric reaction function from equities. And by asymmetric I mean if you look

at ... you know, the conflict now's been going on for you know, over six months. You can go back and look at the nine or ten instances of, you know, rates rising, rates falling, oil rising, oil falling.

And you go and say "How did equities respond in each of these individual instances?" And it turns out that during periods of geopolitical escalation, where yields were rising, the 10-year yield, the 30-year yield was rising, oil was rising, for every 10 basis points that the 30-year was rising, the equity market was falling by about 1.5%.

Now, on the flip side, when you had de-escalation, when the situation looked better, when rates were falling, for every 10-basis-point decline, you had equities rising by 3%, right? So, 10-basis-point increase, equity's down 1.5%, 10-basis-point decline, equity's up 3%. So my point with all of this was even if you don't have a great sense of what's going to happen geopolitically, and let's be honest, Liz Ann, I don't think any of us have any crystal ball into what's happening.

LIZ ANN: No.

ERIC: If we think we do, we're probably misguided. Even if you don't, if you can't predict how things are going to turn out a day from now, a week from now, a month from now. What we do know is that equity markets have been, historically been very resilient around these sorts of shocks and are increasingly becoming resilient to this shock. And so I think the number one thing is you can't be frozen here because what we have seen is that even if you don't know how the what the probabilities look like, we do have a sense of this asymmetries of outcomes depending on what that looks like. So that's kind of number one.

And then the other two factors that are really important in our decision were positioning, right? I think it's really notable that when we look at equity positioning in the U.S. right now, it's right around neutral historically. And we have data that goes back to 2010. So we're right around average, we're right around neutral historically. Despite the fact that the S&P and the NASDAQ are both flirting with all-time highs. So that's actually really notable.

And then the second point, which is, you know, think the other area where a lot of investors are worried about is the rates market. You've seen obviously a huge drawdown in rates portfolios over the past three or four weeks. And so I think we're all kind of waiting for like a situational awareness moment, right? We're all waiting for this moment where the last shoe is dropped, full capitulation, full deleveraging has happened. And we think that that that has probably happened already now, right? And when we look at positioning in the rates market, especially in the front

end of the curve, the belly of the curve, a lot of the longs that have been built up since the Fed started cutting rates in 2024, those have now been almost fully taken out, right? So I think the combination of the leveraging across the rates markets, very supportive positioning in equities, and then this asymmetry around how the market, equity market, is responding to these shocks up and down give us confidence that you know going into year-end I would expect a pretty strong seasonal pattern.

LIZ ANN: Alright. You know, the equities asset class is a big one. It's got lots of components to it. So what within that upgrade, what are the biases from a cap perspective, from a U.S. versus international perspective? Where do you think investors should lean in the context of a more favorable position in equities?

ERIC: I'll be really boring here, Liz Ann, and unfortunately the answer is large-cap tech stocks, right? And so I think everyone is waiting for a broadening out. Everyone's waiting for other sectors to take leadership. The reality is if you kind of go throughout time, certainly over the last five or six years, it's very, very rare to get a broadening out. It's very rare to have market leadership when it's not driven by tech. And the only times that that really happen are when you have an overextended level of positioning in tech, and therefore this rotation almost necessarily has to happen. That's not where we are right now.

So positioning in tech has come off significantly from where we were in the late spring, early summer when semis were flying high. And it actually looks pretty neutral right now. So pretty supportive. And so if you believe that large-cap tech is going to lead the U.S. rally, it's very hard to recommend anything outside the U.S. Perhaps parts of Asia, but really in terms of these large markets, the U.S. is very growth driven, it's very tech driven and certainly versus European markets, versus U.K. markets, if you're if you're long tech then you kind of necessarily have to be long with the U.S.

LIZ ANN: Do you do work on emerging markets? Because that's where performance has been pretty stellar over the last several years relative to the U.S. equity market.

ERIC: Yeah, we do a lot of work on emerging markets, and we have quite a bit of data around markets like Korea and Taiwan and Brazil and the entire spectrum. I think we've found some pretty fascinating things happening in emerging markets recently as well. If you consider markets like Taiwan and Korea emerging markets, you know, the history behind EM, and this is not just in equities, this is in and fixed income and people talk about this in FX a lot, this idea that usually in these markets they are push rather than pull markets, right? In other words, markets in EM tend to benefit when things are really good in developed markets and interest rates are low

and money starts to flow out. And so what you historically see is when you get large foreign inflows into these foreign markets like Korea, like Taiwan, that's usually when markets really start to rally domestically.

The last year or so has been really, really unusual. This is really the first time that we've seen it in our 15 years plus of the data that we've been tracking, where markets have been going up in Korea and Taiwan for obvious reasons, and yet foreigners have been leaving these markets. So, what that's really telling you is the marginal bid, the price discovery, the price setter is coming domestically. So the aggressive bids are really coming domestically.

And I think that really speaks to the maturation in these markets, right? So we know Korea and Taiwan are already very kind of retail heavy, retail dominant markets. but it's been the first time that we've seen domestic investors really driving price in these markets. And it does kind of change the way that you think about these markets going forward.

LIZ ANN: Where do you see the most and least crowded trades right now? At the asset-class level, at the sub-asset-class level?

ERIC: It's a good question. I think we are actually now at a place where a lot of the really crowded trades a month ago, three months ago, have largely unwound. And so it's about as blank of a slate as you can get. You know, in equities we were clearly overextended back in late May, which is why we downgraded our view.

That has come off significantly. Like I said, we're right around neutral.

In the rates market, as I mentioned earlier, a lot of that length has come out and we're back down to around neutral in the rates market as well. So, you know, we don't often say this, but this is one of probably the most compelling times where the stuff that's happening outside of positioning is really, really going to drive what happens for the next three to six months. It really is a blank slate right now.

LIZ ANN: One more micro level question that I want to close with a broader one. We've done some work recently, and I'm not sure if it's the type of work you do as well. So if it's not, say, "I don't have an opinion." It's totally fine. On a daily, rolling daily basis, you know, negative beta, and there's a record high percentage of the S&P right now trading with a negative beta. And for those who don't know what that means, it simply means stocks that are moving in the opposite direction of what the S&P 500 index is doing on a day-to-day basis. And there have been some, you know, warning messages out there from various firms that track that from a technical

standpoint. Is that something you look at or is that something that investors should be mindful of?

ERIC: Yeah, I think ultimately you're talking about dispersion, right? So dispersion has grown materially over the course of this year. That, I suspect, is ... it's a function of a number of different things. It's a function of the fact that these energy price and rate shocks have very idiosyncratic impacts, right? So if you are an energy company, obviously it works out really well. If you are home building, you work in the home building space or you're an airline or you're really driven by consumer products, then these shocks are going to really hurt. And then if you're a software company, it doesn't really matter. So software companies have very little correlation. So I think we often talk about markets being like stock-pickers markets or are or better environments for picking sectors. This is probably one of those. And I think you know the dispersion that you're talking about is really a function of kind of the separation that's happening.

LIZ ANN: Alright, so last question, let's go a little bit bigger picture. You recently wrote a report, I think earlier in September, where you guys talked about your framework learnings over the past year, which is, to the point you made about your tactical views tend to be with two to three months, so this is a little bit longer term. So what were what were some of the most relevant and compelling learnings around your framework that you pointed out in that piece?

ERIC: I think one of them was this notion that, you know, look we've leaned a lot historically on looking at U.S. markets from a positioning standpoint. And certainly we've used that same framework for other markets. But I think what we're seeing increasingly is this is just a really good framework for pretty much any market, right? And so I'll give you the example. In the U.S., for example, the average three-month forward return in the S&P is about 3%. When positioning is credit long, that's a negative return. When positioning is credit short, the market is up typically 10% or more. So you get this vast dispersion. But that's true even outside the U.S. You look at Europe, for example, and from a relative perspective, when European positioning is under-owned versus the U.S., your return versus the U.S. is like plus 13%, 14%, and then when it's over-owned, it's negative.

And so I think we're seeing the same thing in the U.K., we see the same thing in Brazil, we see the same thing across EM. This kind of idea of using positioning and supply and demand and flows in trying to forecast two or three month returns is really compelling, you know, even outside of the really, really big markets. So that's one of the things that I think we've been focusing a lot more on. The point I mentioned earlier around the changing nature of retail flows, right, and the role that these prediction markets are playing.

Again, a couple of years ago I would not have thought that you'd have seen such an impact on retail activity, but I think it's been dramatic. And it's very hard to ignore just how big of a shift that that we're seeing from retail activity moving out of public markets and into these prediction markets. And then certainly around EM, right? This idea that foreign flows historically have been so important and now you are seeing the emergence of really powerful domestic investor base in places like Korea and Taiwan that are not just active but really pushing price, moving price around, which is really unusual. So I think, you know, the ultimate lesson for us was you can't have a set of, you know, theories or frameworks for how the world works and not never change that. You have to kind of be dynamic and that's really what we've done over the last 12 or 13 years is, you know, we're constantly making sure that our vision of reality checks out and I think that's really paid off in recent years.

LIZ ANN: Well Eric, this has been great, just a clinic. And I absolutely love Vanda's work as you well know, and we really appreciate that you came on to share some of that work with our listeners. So thank you.

ERIC: Appreciate the opportunity, Liz Ann.

COLLIN: So Liz Ann, as we always do, let's look ahead to next week. So what matters most for you and what do you think that investors can be paying attention to?

LIZ ANN: Well what matters most is actually not next week, but what is coming up the day that this episode drops, which is the jobs report. So I will tell folks that you don't get the benefit of hearing our views on that, but probably the easiest way to get our in-the-moment thoughts when we get the jobs report release is, shameless plug here, follow us on our X accounts, on our Twitter accounts, where we will post reactions. But other than that, it's a relatively quiet week next week, with the exception of maybe the FOMC minutes, the Federal Open Market Committee minutes. I know that's those are data points that you peruse pretty intently. At the end of this week we will have gotten part of the ISM manufacturing and services. I think manufacturing comes first, but then we'll get the services version of it next week. And then also University of Michigan consumer sentiment to see whether that continues to track at a very low level. We did this week get consumer confidence out of the Conference Board and that kind of sunk like a stone. And that metric tends to key more off of what's going on in the labor market. So keep that in mind. Where University of Michigan's consumer sentiment tends to key more off what's going on in inflation. So how about you?

COLLIN: Well, you mentioned the jobs report Friday, which will come out after we're recording this. But I think that's important because I believe the risks to the bond market are sort of asymmetric because a lot of Fed officials have highlighted

that they don't really see too much inflationary pressures from the labor market. So if the jobs market or the jobs report comes out, say on the softer side, I don't know how much that will pull down yields, but if we get a stronger report, I think we could see yields move up, move up more than they might move down if it was a weak report, just because that would kind of, you know, bring to the forefront the idea that the economy is strengthening, as Kevin Warsh alluded to at the FOMC meeting earlier this month.

You mentioned the FOMC minutes, the Federal Open Market Committee minutes. You know, those are always important because we get a deeper look at what the discussion was like. But we've already heard from so many officials following the meeting that that's probably more important because we can actually put a name to a quote. And the theme we've gotten from officials is that, you know, more hikes are likely necessary and that the risk is that these supply shocks end up being persistent in terms of what the impact is to broad inflation readings.

And then finally, we have a 10-year Treasury auction next week. I think that will be very interesting because right now the 10-year Treasury yield is above 5%. So, you know, you would think that should encourage demand for the 10-year Treasury auction. If there was weak demand at such a high yield relative to where we've been for the past 15 or 20 years, that would that would be a little bit concerning, because it would suggest that investors are a little bit nervous about, you know, investing for 10 years with the Treasury right now. There could be a number of reasons why, but if it was weak, that could pull yields even higher, because it could suggest that yields might need to continue moving up to continue to attract the marginal buyer out there.

That's it for this episode. As always, thank you for listening. We really appreciate it. Now, if you don't want to wait a week until the next episode, as Liz Ann just mentioned, you can always keep up with us in real time on social media. I'm @CollinMartinCS on both X and LinkedIn. That's Collin with two L's, and the CS is for Charles Schwab.

LIZ ANN: And I'm @LizAnnSonders on X and LinkedIn. Still have lots of imposters, so make sure you're following the real me. And you can find all of our written reports, not just mine and Collin's, but all of our brilliant colleagues at Schwab Center for Financial Research. And they often include lots of charts and graphs and tables for those of you visually oriented. And they can be found at schwab.com/learn.

Now, in our interview, Eric mentioned superforecasters. We just happen to have an episode of our sister show, *Choiceology*, that is all about superforecasters and includes an interview with Barbara Mellers, who co-founded the Good Judgment

project that Eric mentioned. You can find that by searching "*Choiceology* and superforecasters" or visiting schwab.com/choiceology.

And if you want to support our show, please consider leaving us a review on Apple Podcasts, a rating on Spotify, or feedback wherever you listen. And we will be back with a new episode next week.

COLLIN: For important disclosures, see the show notes, or visit schwab.com/OnInvesting, where you can also find the transcript.