MARKETS AND ECONOMY

Schwab Market Perspective: Price Shock

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Liz Ann Sonders

Jeffrey Kleintop

Kathy Jones

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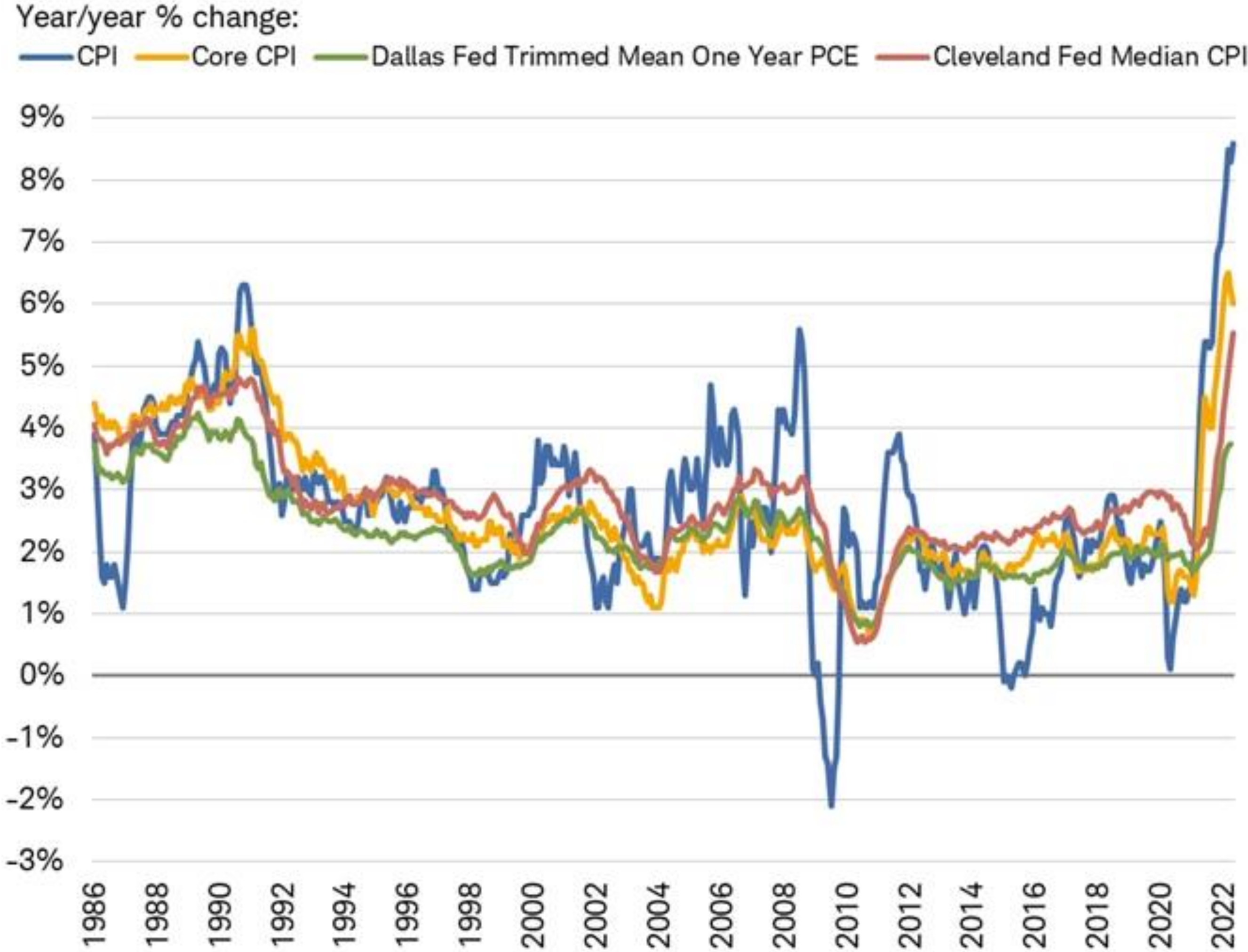
Inflation continues to run hot, raising the prospect that the Federal Reserve will tighten monetary policy more aggressively than expected—possibly tipping the U.S. economy into recession. The Fed has committed to raising interest rates and reducing its bond holdings until inflation recedes. Other central banks around the world also are stepping up their plans to hike interest rates.

U.S. stocks and economy: Hits keep coming

The U.S. economy remains under significant pressure from inflation. The Consumer Price Index (CPI), driven largely by surging food and energy prices, accelerated at an 8.6% annual rate in May—the highest since December 1982. Energy spending as a percentage of total consumer spending has grown over the past year and is approaching 1%, a level that heightens stress for consumers—particularly lower-income consumers, who spend a greater share of their household income on items like gasoline.

That said, food and energy aren't solely to blame for inflation. At this point, prices are up across many categories. Alternative measures that attempt to deliver a less "noisy" read on inflation (by screening out volatile categories or focusing on the median) are also rising at their fastest rates on record. The Dallas Fed excludes the most extreme price changes in consumer goods and services each month, while the Cleveland Fed excludes all price changes except for the one in the center of the distribution of price changes. These measures' acceleration suggests that taming inflation in food and energy alone won't solve the problem.

Inflation heat intensifies

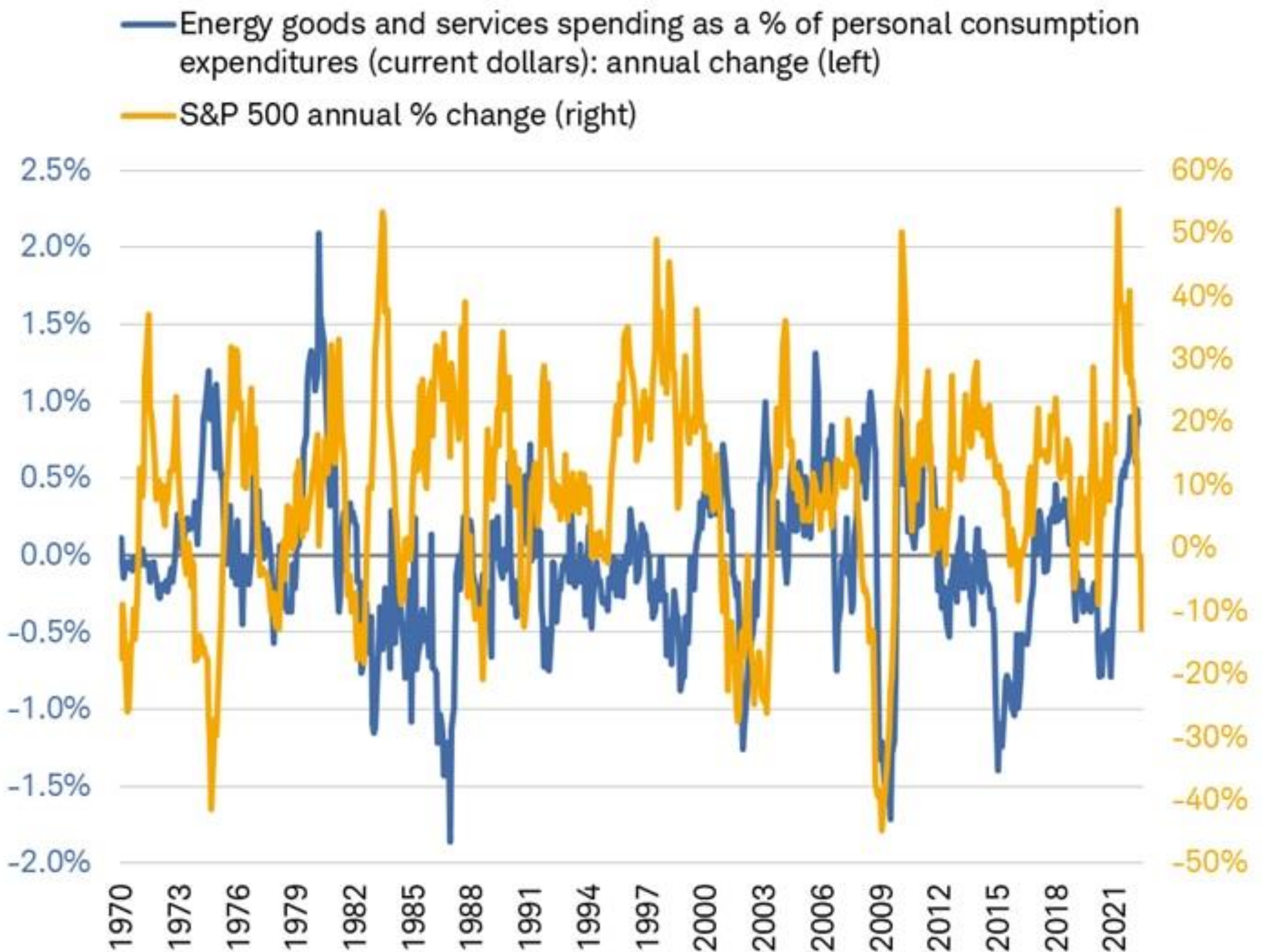


Source: Charles Schwab, Bloomberg.

CPI, Core CPI, Dallas Fed Trimmed Mean One Year PCE, which excludes the most extreme price changes in consumer goods and services, as of 5/31/2022, and Cleveland Fed Median CPI, which excludes all price changes except for the one in the center of the distribution of price changes, as of 4/30/2022.

Even wealthier consumers, who can often rely on greater savings or a stronger stock market, could be feeling the pinch as stocks have fallen. The annual change in the S&P 500® Index has dipped into negative territory and is down 12.7% from one year ago—the worst annual return since the global financial crisis. While that may not translate into actual losses for investors who haven't sold investments, even paper losses can hurt households' confidence.

Losing energy and gains

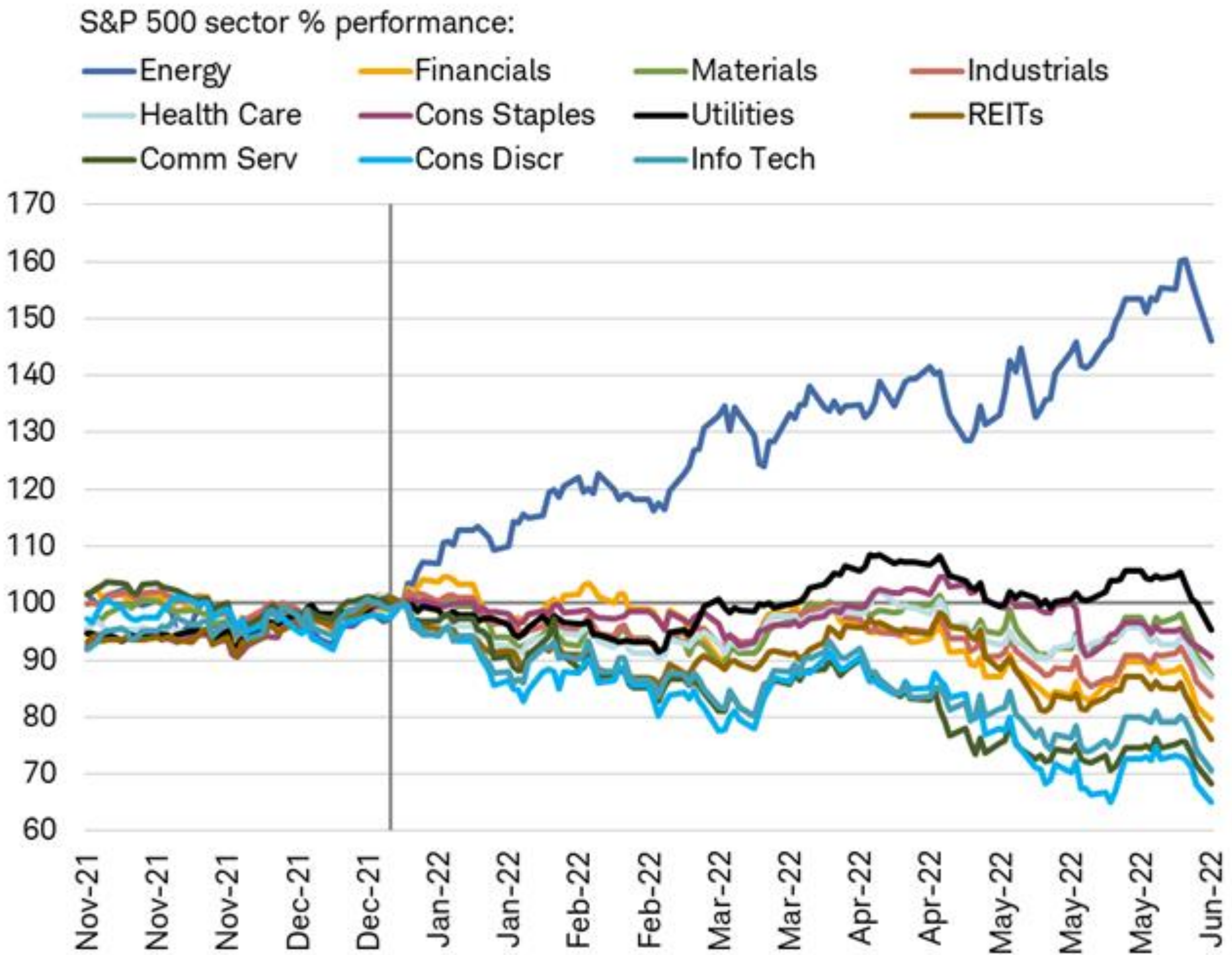


Source: Charles Schwab, Bloomberg.

Energy spending as of 4/30/2022. S&P 500 annual change as of 6/13/2022. **Past performance is no guarantee of future results.**

With the exception of the Energy sector—where the spike in oil prices has boosted profits—all the other sectors within the S&P 500 have experienced some degree of weakness since the index's peak on January 3, 2022.

Energy has been an outlier



Source: Charles Schwab, Bloomberg, as of 6/13/2022.

Data indexed to 100 at 1/3/2022. An index number is a figure reflecting price or quantity compared with a base value. The base value always has an index number of 100. The index number is then expressed as 100 times the ratio to the base value. **Past performance is no guarantee of future results.**

We don't currently have any sector overweight or underweight recommendations, partly due to the highly volatile nature of the market and the uncertain trajectory of economic growth. Instead, we continue to encourage investors to take a factor-based approach, with a focus on high-quality segments of the market characterized by positive earnings revisions, low volatility, and high free-cash-flow yield.

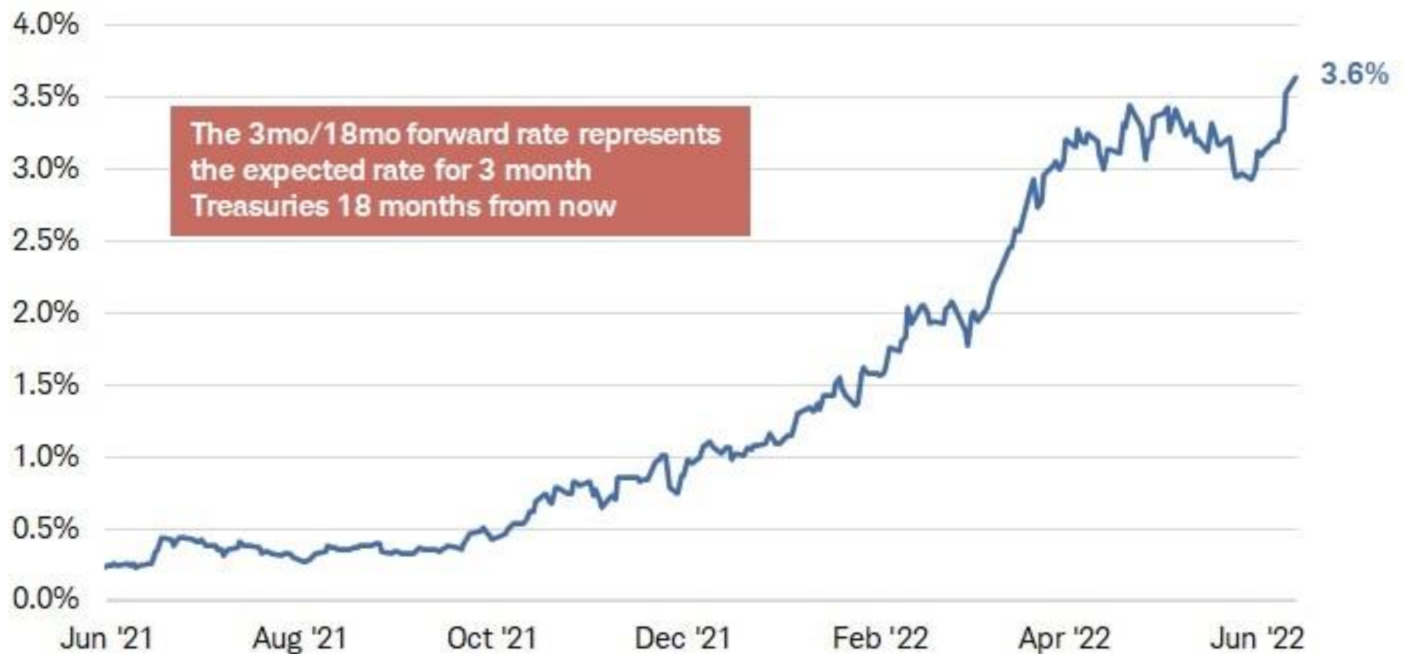
Fixed income: The tide of liquidity keeps rolling out

With no relief on inflation in sight, central banks around the world are ratcheting up their plans to hike interest rates. The result has been a rapid resetting of expectations about the degree of monetary policy tightening it will take to bring inflation lower, and a sharp selloff in the bond market and risk assets.

The May CPI report squashed hopes that inflation would be coming down soon. The problem for the Fed and other major central banks is that a lot of the inflationary pressure stems from supply-side issues, which they can't control. The only option available is to slow economic growth enough to bring domestic demand down to meet the constrained supply.

Markets are pricing in a steep rise in the target for the federal funds rate to the 3.75%–4% region by the middle of 2023. That represents a huge leap from expectations of 2% in early March and, if realized, would be the highest fed funds rate since 2008. When combined with the Fed's quantitative tightening program, policy would be well into restrictive territory.

The forward rate indicates short-term rates will hit 3.6% in 2023

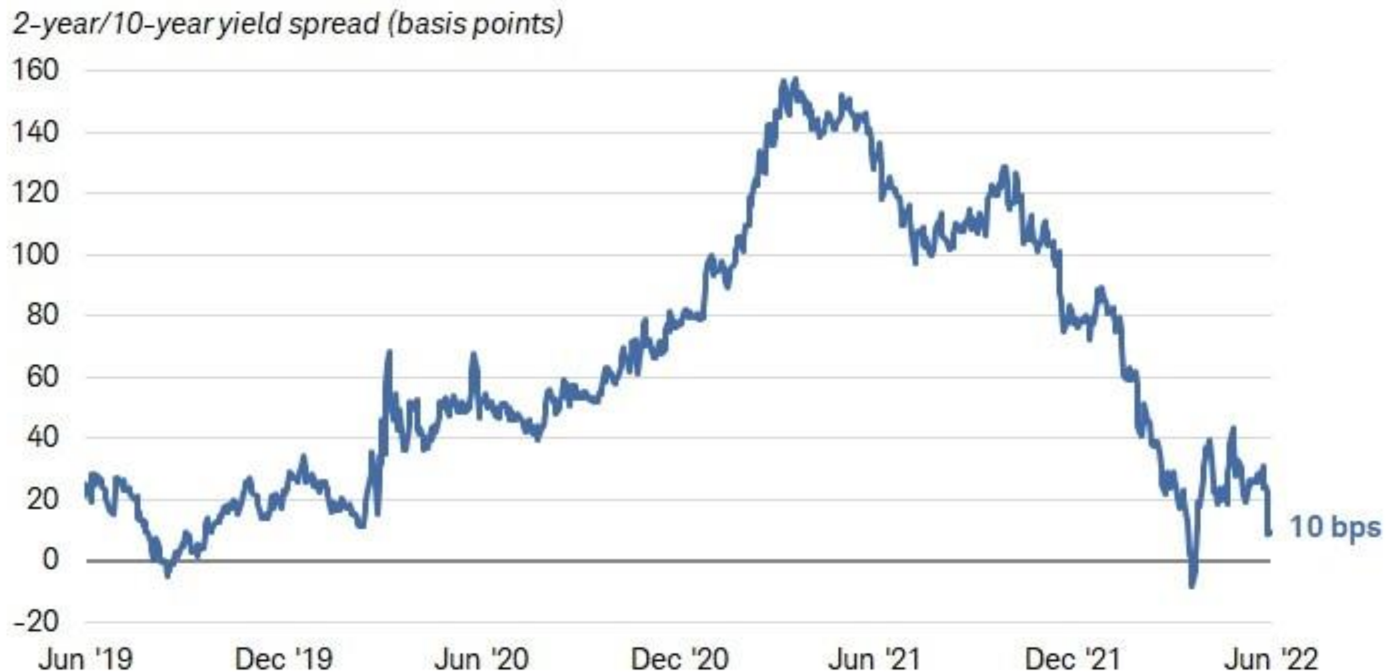


Source: Bloomberg. USD OIS FWD swap 18M3M (G0025 18M3M BLC2 Currency). Daily data as of 6/13/2022.

Note: A vanilla interest rate swap is an agreement between two counterparties to exchange cashflows (fixed vs floating) in the same currency.

Is it enough? It's too soon to know, but the market is implying it may be too much. Treasury yields typically converge at the peak fed funds rate during an interest rate hiking cycle. If the implied peak in the fed funds rate proves to be accurate, then intermediate- to long-term yields still have room to rise moderately. However, the yield spread between 10-year and two-year Treasuries recently inverted (with two-year yields above 10-year yields)—historically an early warning signal of recession. It suggests the market thinks the Fed may risk hiking rates too high.

Yield curve inverts on expectations for tighter Fed policy

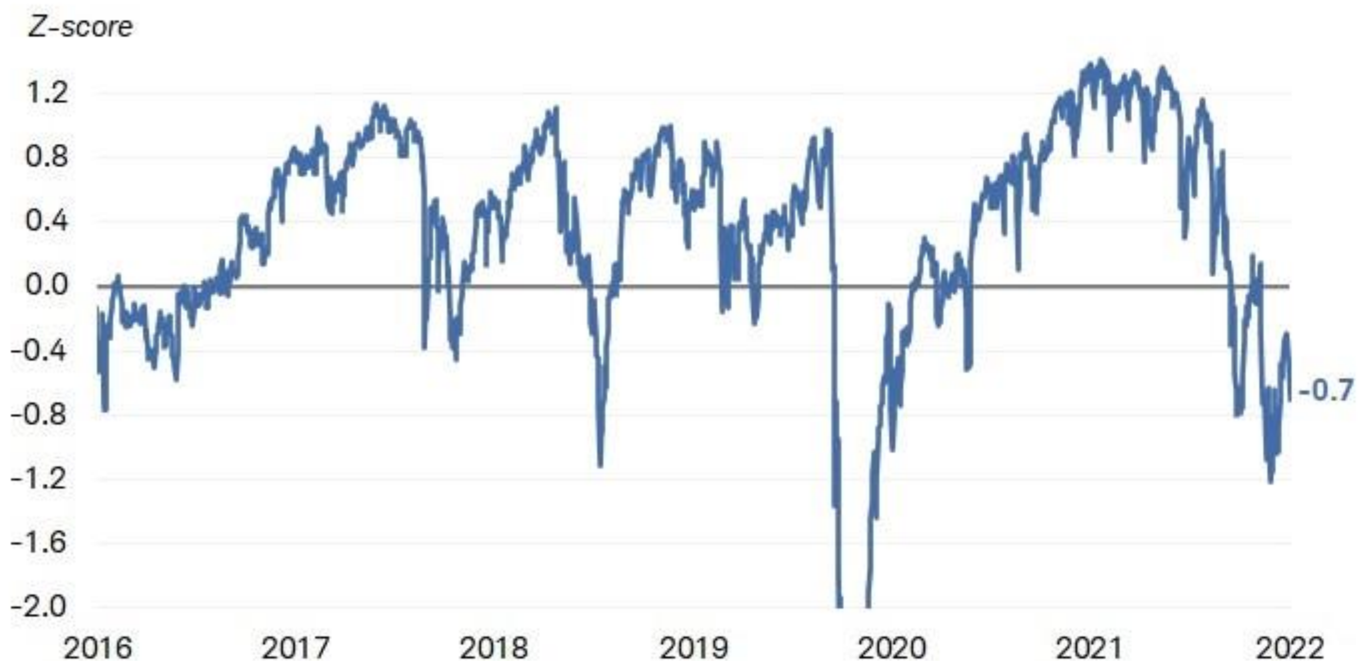


Source: Bloomberg. Daily data as of 6/13/2022.

Note: The rates are composed of Market Matrix U.S. Generic spread rates (USYC2Y10). This spread is a calculated Bloomberg yield spread that replicates selling the current 2-year U.S. Treasury Note and buying the current 10-year U.S. Treasury Note, then factoring the differences by 100.

In addition, credit spreads—the difference in yield between Treasuries and corporate bonds of similar maturity—have increased as investors favor Treasury bonds over bonds exposed to the economic cycle. The dollar has also soared by more than 7% year to date. A strong dollar tends to add some protection against hotter inflation and slow growth. When combined, these factors signal financial conditions may have tightened enough to tip the economy toward recession.

Bloomberg Financial Conditions Index shows tightening conditions



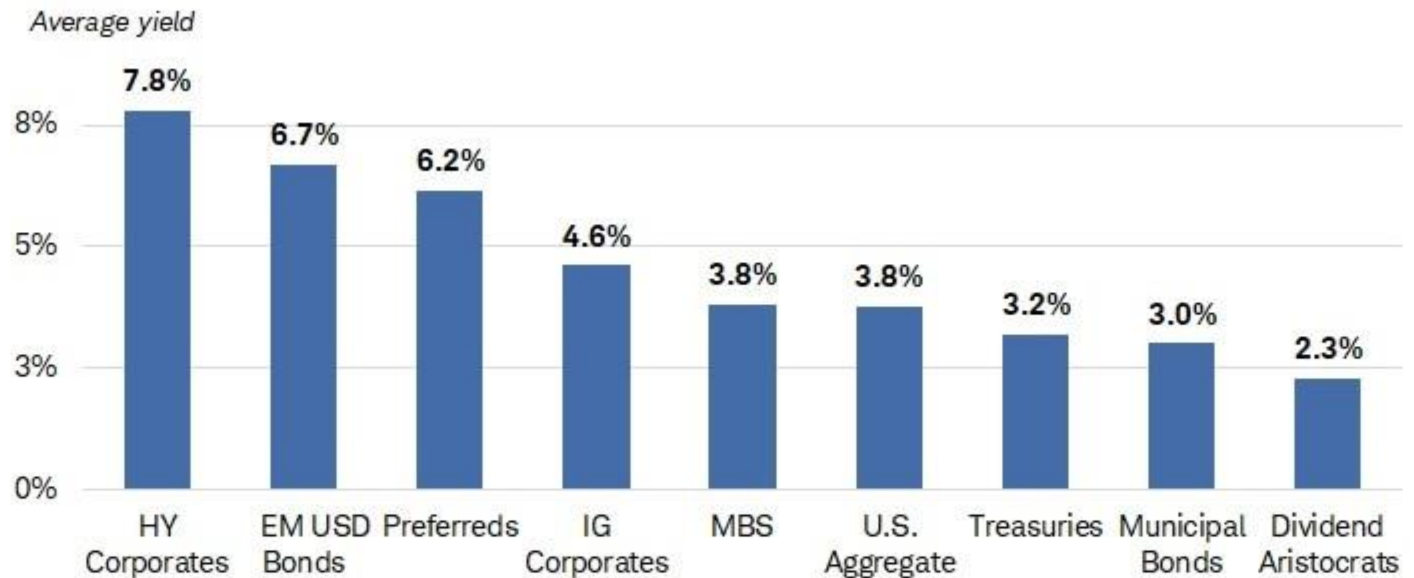
Source: Bloomberg. Bloomberg U.S. Financial Conditions Index (BFCIUS Index), daily data as of 6/13/2022.

The Bloomberg U.S. Financial Conditions Index tracks the overall level of financial stress in the U.S. money, bond, and equity markets to help assess the availability and cost of credit. A positive value indicates accommodative financial conditions, while a negative value indicates tighter financial conditions relative to pre-crisis norms. Y-axis is truncated at -2.0 for scaling purposes. For reference, the low occurred on 3/24/2020 and was -6.33. The Z-Score indicates the number of standard deviations by which current financial conditions deviate from the average. A positive value indicates accommodative financial conditions, while a negative value indicates tighter financial conditions

Since it can take some time to see the effect of monetary policy on the economy, the impact of tightening may not be evident until later this year. In the interim, bond markets are likely to remain volatile with a risk of higher yields.

While it has been a brutal year for fixed income investors to date, the drop in prices and rise in yields presents potential opportunities for those looking to generate income from their portfolios. Bonds now have yields that are significantly higher than those found in dividend-paying stocks.

Yields are higher than people realize



Source: Bloomberg, as of 6/10/2022.

Indexes represented are: Bloomberg U.S. Aggregate Bond Index (U.S. Aggregate), Bloomberg U.S. Corporate Bond Index (IG Corporates), Bloomberg U.S. Corporate High-Yield Bond Index (HY Corporates), Bloomberg U.S. Municipal Bond Index (Municipal Bonds), ICE BofA Fixed Rate Preferred Securities Index (Preferreds), Bloomberg Emerging Market USD Aggregate Index (EM USD Bonds), Bloomberg U.S. MBS Index (MBS), Bloomberg U.S. Treasury Index (Treasuries), and the S&P 500 Dividend Aristocrats Index (Dividend Aristocrats). Yields shown are the average yield-to-worst except for the Dividend Aristocrats which is the average dividend yield. **Past performance is no guarantee of future results.**

For investors who are underweight fixed income or have a high level of short-term holdings, we suggest gradually adding duration in core bonds such as Treasuries, and investment-grade municipal and corporate bonds. We are more cautious toward lower-rated, riskier bonds such as high yield and emerging market bonds.

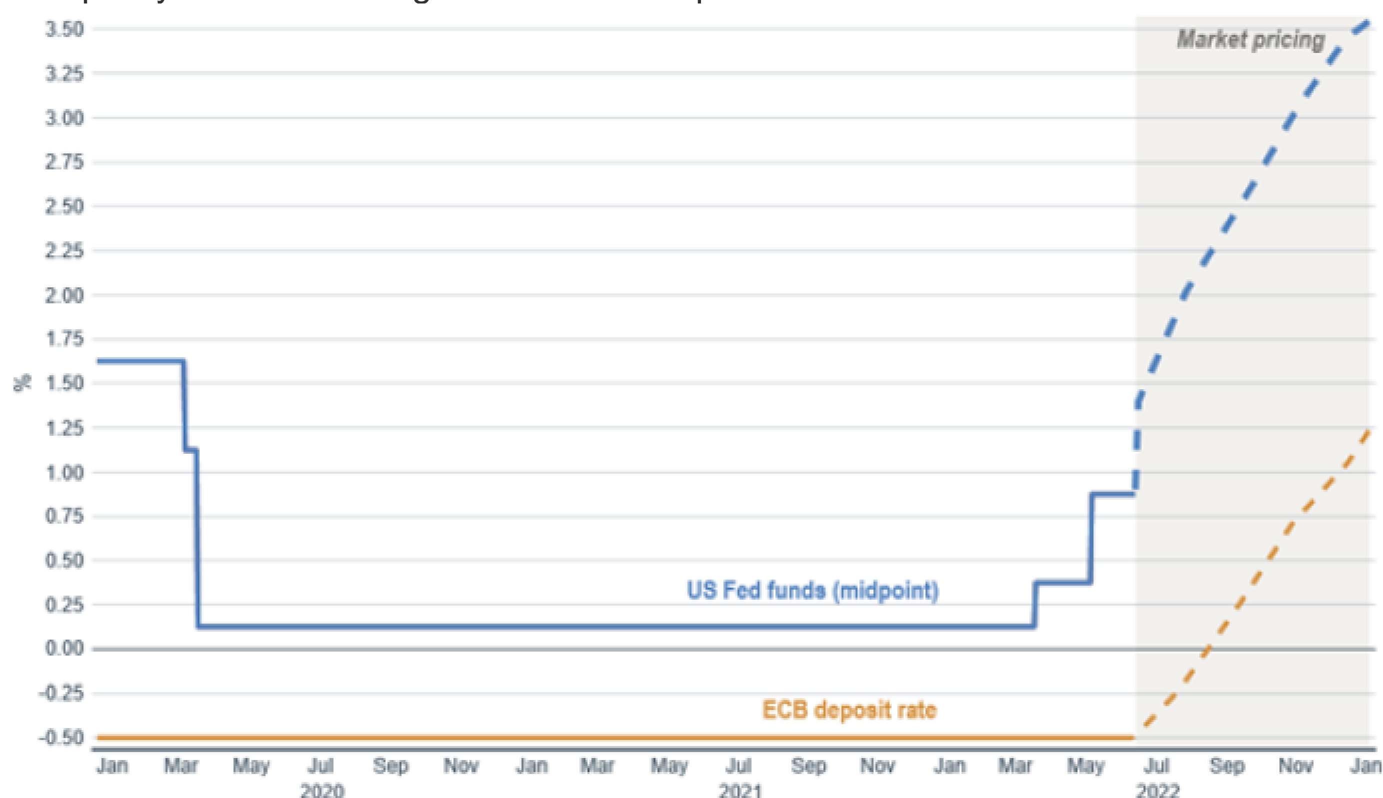
Global stocks and economy: ECB is prepared for liftoff

After 11 years without a rate hike, the European Central Bank's (ECB) streak is about to come to an end. While holding rates steady at its June meeting, the ECB said it intends

to raise the policy interest rate by 25 basis points (bps) in July, with another 25-bp or 50-bp rate hike to follow in September.

For the second half of this year, the market seems to have priced in a series of hikes for the ECB, in line with the Fed's expected course. That could offer some support to the euro versus the U.S. dollar.

ECB policy rates set to begin to track Fed's path

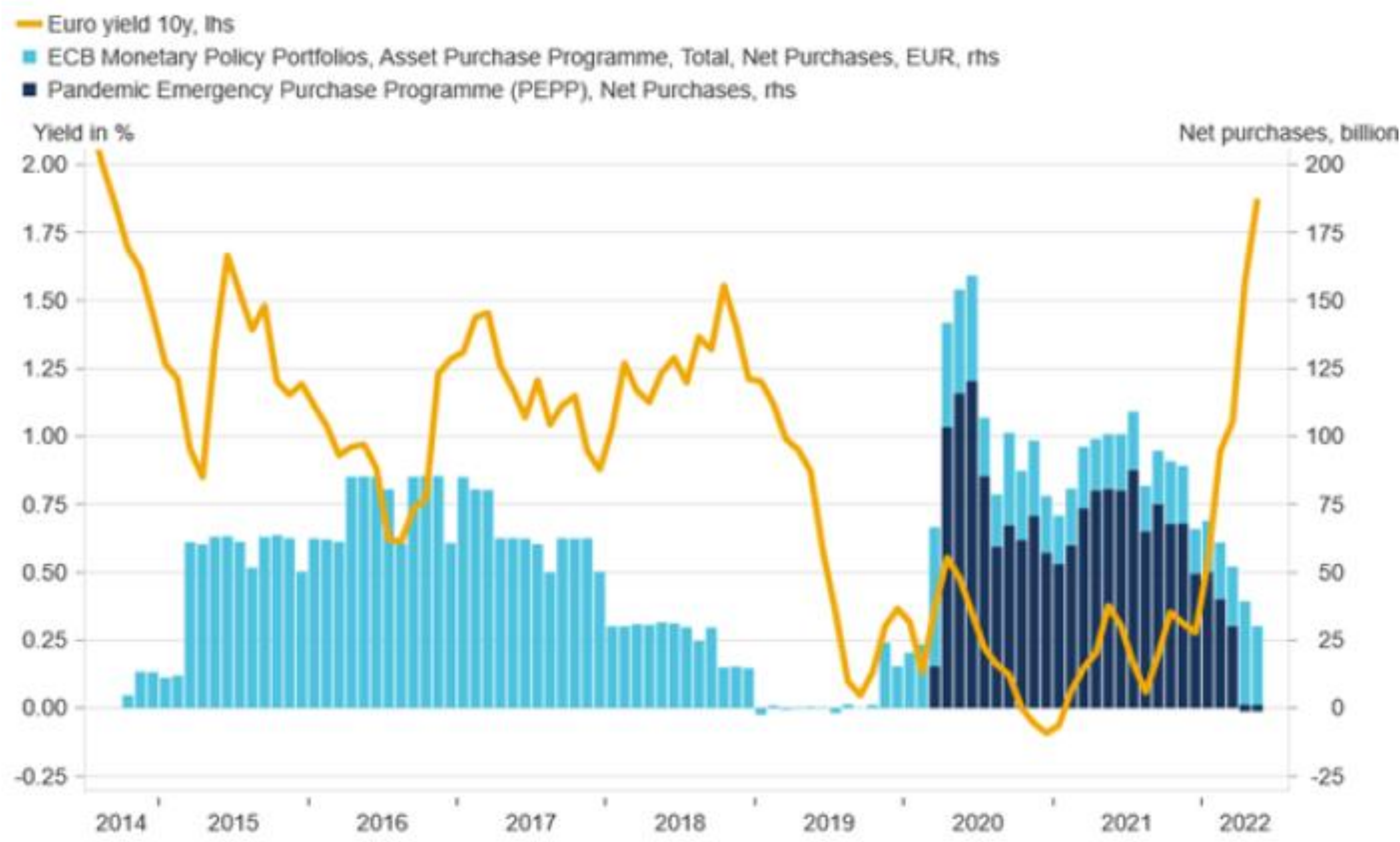


Source: Charles Schwab, Macrobond, Federal Reserve, European Central Bank, Bank of Japan, Bloomberg data as of 6/13/2022.

The ECB also confirmed it will end its quantitative easing (QE) program on July 1, ahead of the rate liftoff expected on July 21. Bond yields in the euro zone have already been climbing sharply, while central bank bond purchases have been winding down. This contrasts with the end of QE in 2019, which saw yields plunge. Investor demand

more than offset the lack of central bank purchases while Europe's GDP weakened, turning negative by the fourth quarter of 2019 (ahead of the pandemic).

ECB net asset purchases and Eurozone bond yields



Source: Charles Schwab, Macrobond data as of 6/9/2022.

The euro 10-year bond yield is the GDP-weighted 10-year bond yield of Eurozone member countries.

In addition to managing the overall policy interest rate, another one of the ECB's balancing acts is to mitigate unwarranted widening of spreads among the yields of its member countries. If this fragmentation goes unaddressed, Europe's fiscally weaker countries, notably Italy, will feel disproportionately impacted by tightening of financial conditions.

The ECB fought a hard battle to reduce spreads after the European debt crisis of 2010-2012, when rates were hiked and the yield spreads of some countries were as wide as, or wider than, pre-euro zone levels. At its June meeting, ECB President Christine Lagarde emphasized the bank's commitment to preventing fragmentation. Yet, Italy's 10-year government bond yield rose sharply after the meeting, crossing over 4% on June 13, up from around 1% at the start of the year. The Italian yield is now at the widest spread to Germany's 10-year yield (2.4%) since the pandemic-fueled recession in the second quarter of 2020, as you can see in the chart below.

Eurozone spreads widening

Source: Charles Schwab, Macrobond data as of 6/13/2022.

Kevin Gordon, Senior Investment Research Manager, contributed to this report.