MARKETS AND ECONOMY

Schwab Market Perspective: Mixed Signals

August 12, 2022 Liz Ann SondersJeffrey KleintopKathy Jones

Although some recent economic data has been strong, the bigger picture is more nuanced. Some leading economic indicators have begun signaling recession, and the Treasury yield curve is inverted.

The unexpectedly strong July jobs report belied considerable nuance in the broader economic picture. Leading economic indicators and an inverted U.S. Treasury yield curve—historically harbingers of recession—are showing pockets of weakness in the economy. The situation may be similar overseas. Although large overseas economies have fared better this year than many analysts had expected, there are risks to growth for the coming quarters, and Europe's economy is still slowing.

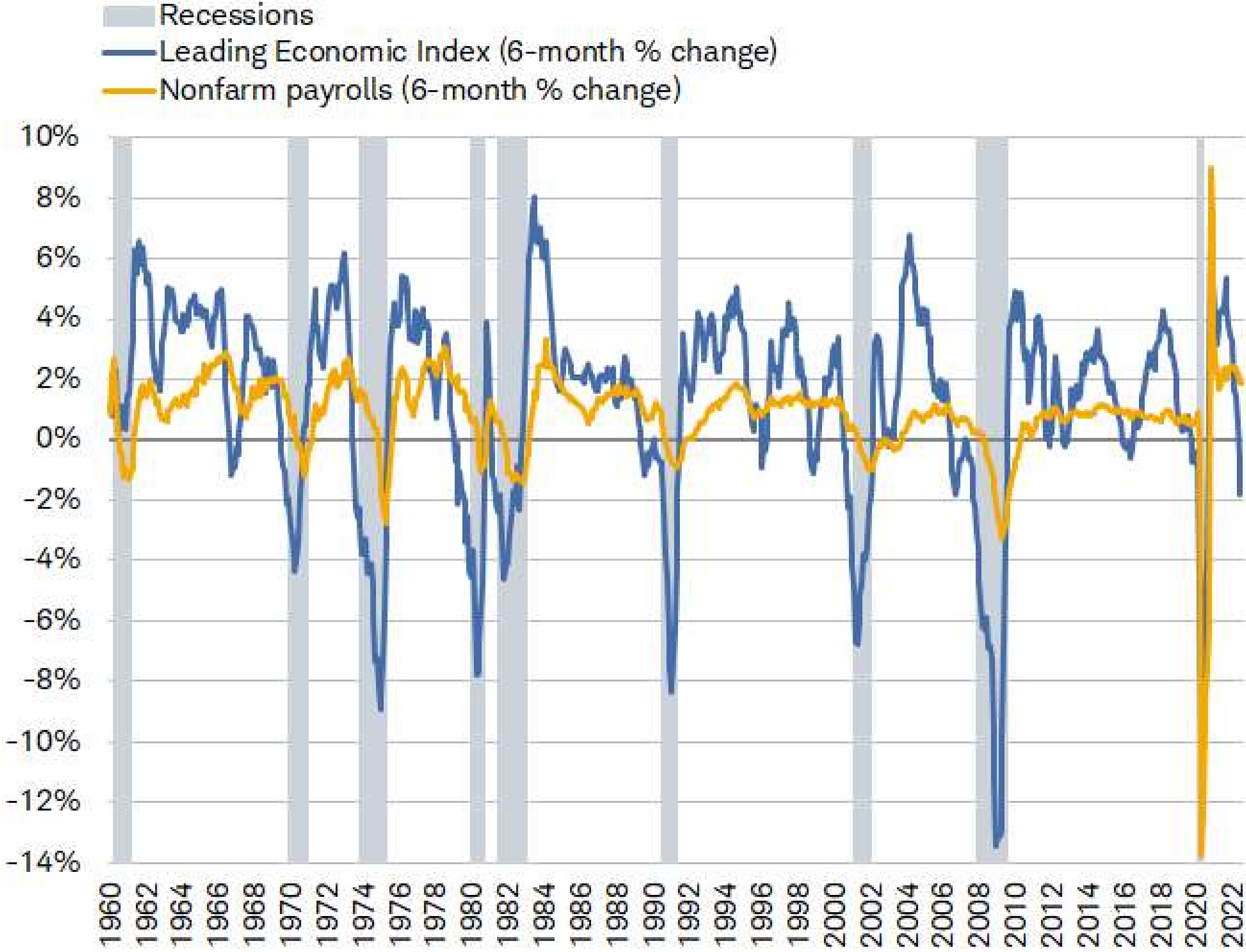
U.S. stocks and economy: Dodging false signals

July's jobs report was undoubtedly hot—wages grew 5.2% year-over-year, and the economy added 528,000 jobs, boosting total payrolls above their pre-COVID peak in February 2020. While bulls cheered these signs of apparent strength, those expecting the Federal Reserve to slow or halt the pace of interest rate hikes were cautious as further signs of labor market tightness emerged.

Bulls may also have felt those payroll gains more than outweighed other deteriorating trends in the economy. However, growing payrolls and recessions aren’t mutually exclusive. There is historical precedent—like in the early 1970s—for continued job growth well after the start of a recession.

Meanwhile, leading economic indicators aren't suggesting a strong backdrop for the labor market. As shown in the chart below, The Conference Board's Leading Economic Index (LEI) has fallen by nearly 2% over the past six months. Excluding the reaction to the pandemic, LEI hasn’t stumbled like this since August 2009. Such a decline is also consistent with prior periods when the economy was entering a recession.

Leading economic indicators are turning



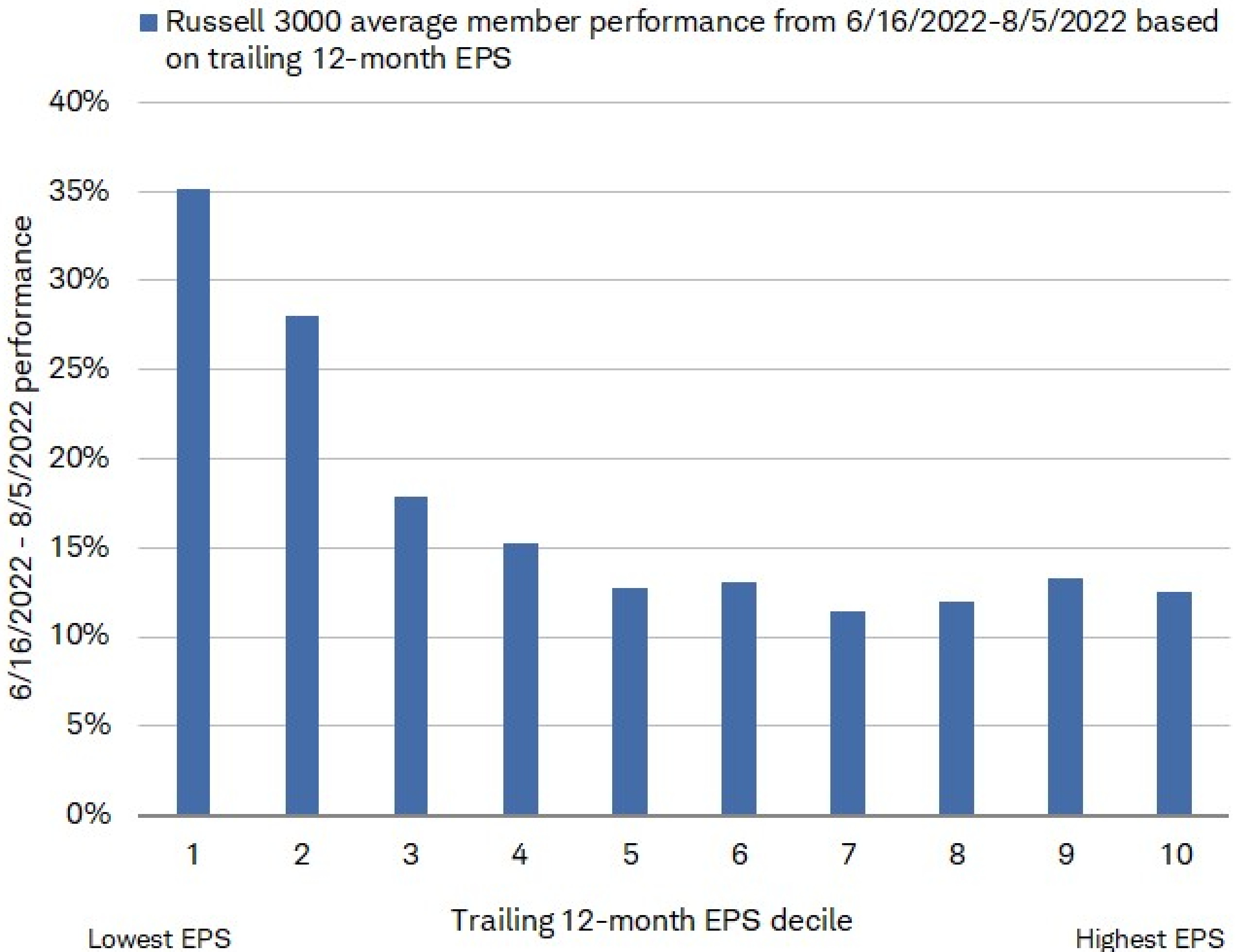
Source: Charles Schwab, Bloomberg. Nonfarm payrolls as of 7/31/2022. LEI as of 6/30/2022.

Y-axis is truncated at 3,000 and -3,000 to account for pandemic-related distortions.

At this point in the economic cycle, it is critical to differentiate between leading and coincident economic indicators. The former—such as job-cut announcements and claims for unemployment insurance—are sending recession warnings. That has always occurred before payrolls—a coincident indicator—turned lower.

It’s possible the stock market isn’t taking full account of the weakness in the labor market and broader economy. As shown below, Russell 3000 index constituents with the weakest earnings growth (i.e., negative or no earnings) have decisively outperformed their higher-quality peers since the most recent trough in mid-June. With the Fed aggressively hiking rates and the economy having slowed considerably, we don't think such speculative segments of the market will continue to outperform.

Weak profits, strong performance



Source: Charles Schwab, Bloomberg, as of 8/5/2022.

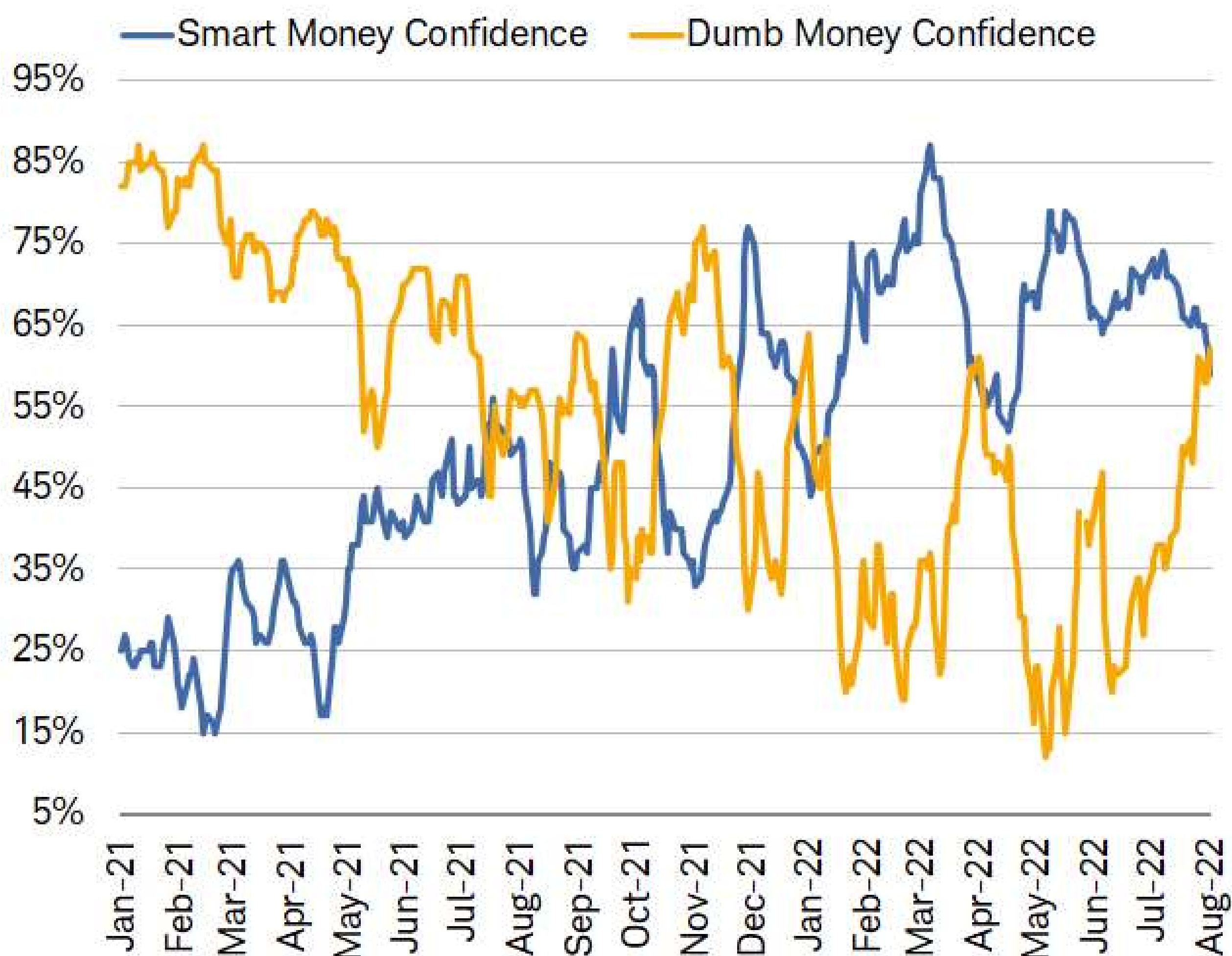
Past performance is no guarantee of future results.

The strong performance of lower quality stocks could give the market a false sense of confidence in the health of the economy. In fact, investor sentiment has been frothy, as shown by the surge in SentimenTrader's "Dumb Money" Confidence Index below. Some of that rise may be justified by decent breadth indicators, but leading economic data would need to turn higher before we could have confidence the recent gains are durable.

Stretched sentiment—at either extreme—is never itself sufficient evidence that stocks are ripe for a reversal. Some investors may be waiting for a negative catalyst to come

along and send stocks lower, but we think the market will face more pressure from slower growth and restrictive Fed policy.

Sentiment turns frothier



Source: Charles Schwab, SentimenTrader, as of 8/2/2022.

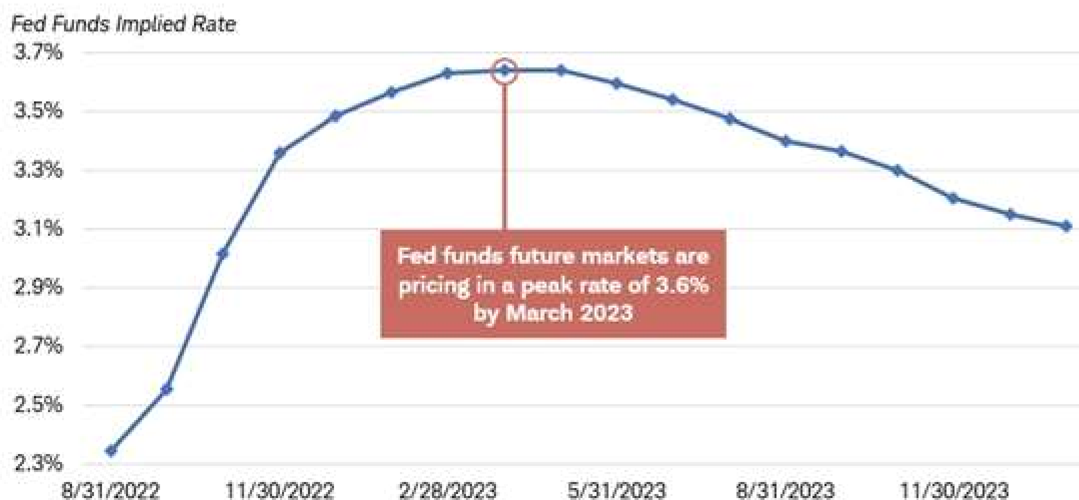
SentimenTrader's Smart Money Confidence and Dumb Money Confidence Indexes are used to see what the "good" market timers are doing with their money compared to what the "bad" market timers are doing and are presented on a scale of 0% to 100%. When the Smart Money Confidence Index is at 100%, it means that those most correct on market direction are 100% confident of a rising market. When it is at 0%, it means good market timers are 0% confident in a rally. The Dumb Money Confidence Index works in the opposite manner.

Fixed income: All roads lead to yield curve inversion

In its campaign to fight surging inflation, the Fed has raised the target range for the federal funds rate four times since this rate-hike cycle started in mid-March. The upper end of the range is now 2.5% compared to a starting level of 0.25%, making this one of the most rapid tightening cycles in over 40 years. At the same time, the pace at which assets roll off its balance sheet (i.e., quantitative tightening) is set to accelerate in September.

With the annual inflation rate still at 8.5% and wage growth running at more than 5%, more rate hikes are likely on the horizon. The current market pricing suggests investors expect a peak in the federal funds rate of 3.6% in the first quarter of 2023, followed by a series of rate cuts that should bring the rate down to 3% by early 2024.

Markets are pricing in a peak by early next year



Source: Bloomberg.

Market estimate of the Fed funds using Fed Funds Futures Implied Rate (FFM2 COMB Comdty). As of 8/5/2022 For illustrative purposes only. Please read the Risk Disclosure for Futures and Options prior to trading futures products. Futures accounts are not protected by SIPC.

Overall CPI growth has reached 8.5% year over year

Source: U.S. Bureau of Labor Statistics. As of 7/31/2022.

Consumer Price Index for All Urban Consumers: All Items Less Food & Energy (CPI XYOY Index) and Consumer Price Index for All Urban Consumers: All Items (CPI YOY Index), Percent Change from Year Ago, Monthly, Seasonally Adjusted. Note: The Consumer Price Index measures changes in the price level of consumer goods and services purchased by households. Core inflation (Core CPI) is a measure of inflation which excludes certain items that face volatile price movements, notably food and energy.

That outlook may be too optimistic in terms of the Fed's actions, but it reflects signs that inflation pressures are abating. Commodity prices have dropped sharply, inventories are rising relative to sales, the U.S. dollar is strong, and global economic growth has been soft.

One of the outgrowths of rapid Fed tightening is an inverted yield curve, where short-term interest rates are higher than longer-term rates. By boosting short-term borrowing costs and reducing the liquidity available to the financial system, the Fed's actions should slow economic growth and cool inflation down the road. In most tightening cycles, long-term yields lag the rise in short-term rates because bond yields reflect

expectations about future growth and inflation, as well as the future path of the federal funds rate.

The inversion of the yield curve in this cycle is one of the steepest in modern history. The yield spread between two-year and 10-year Treasuries, at about negative 40 basis points, has only been this low a few times in the past 40 years. However, there is no theoretical limit to how far it can fall. In the early 1980s, the spread was more than 200 basis points.

The yield curve between short- and longer-term Treasuries is inverted

Source: Bloomberg. Daily data as of 8/8/2022.

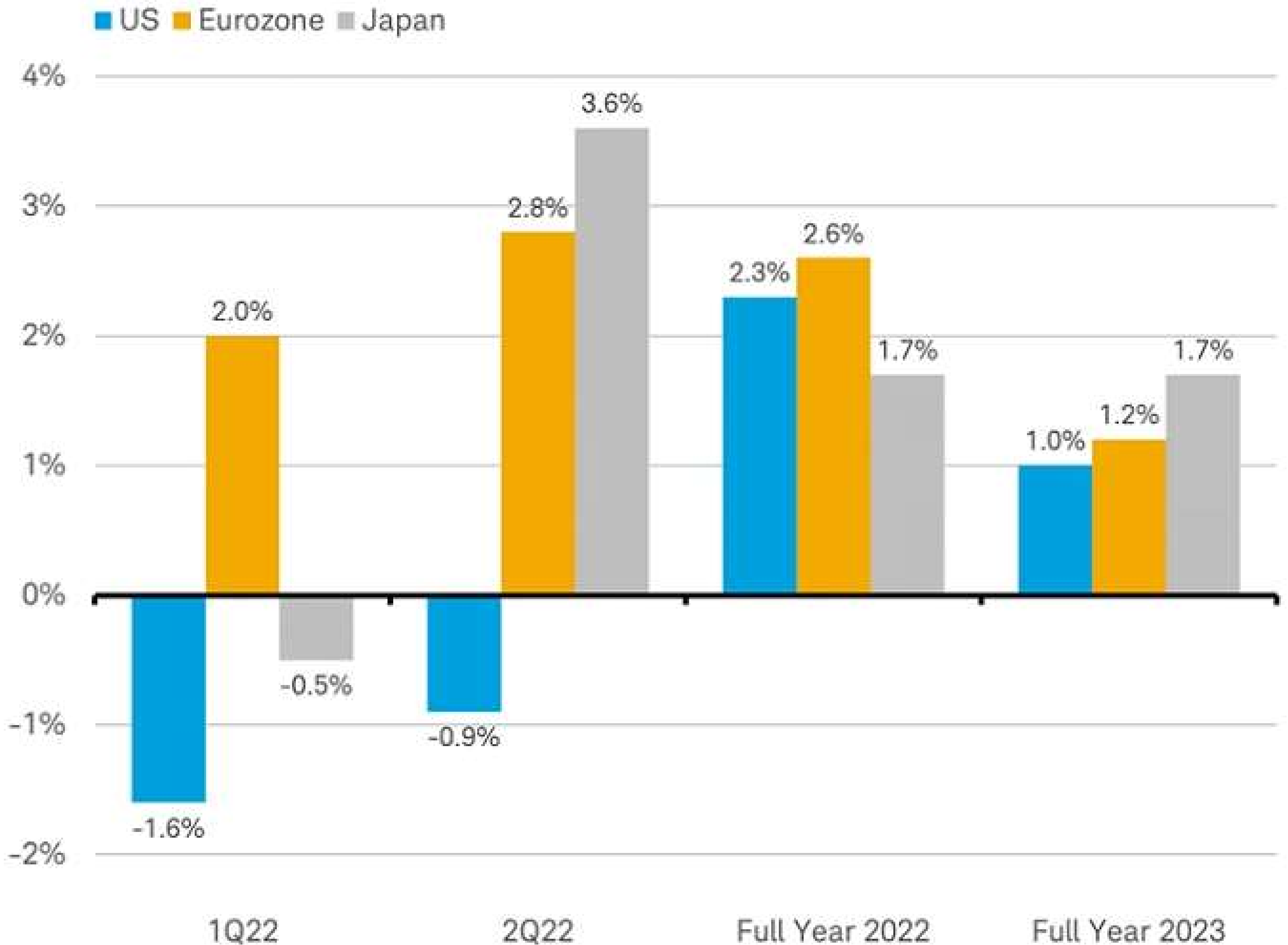
Note: The rates are comprised of Market Matrix U.S. Generic spread rates (USYC2Y10)This spread is a calculated Bloomberg yield spread that replicates selling the current 2 year U.S. Treasury Note and buying the current 10 year U.S. Treasury Note, then factoring the differences by 100.

An inverted yield curve has been a reliable signal of recession on the horizon in the past. Not all two-year/10-year inversions lead to recessions, but they have all led to some slowing in economic growth. The bottom line is that overall yield levels may continue to rise as the Fed tightens policy, but the faster the pace of rate hikes, the more likely it is that the yield curve will invert further.

Global stocks and economy: Earnings recession?

Large overseas economies are faring better than many had feared. Europe grew at an above-average pace in the first half of the year, with second-quarter gross domestic product (GDP) growth coming in at an unexpectedly strong 2.8% on an annualized basis (following a rise of 2.0% in the first quarter). We won't see Japan's GDP growth data for a couple more weeks, but it is expected to come in at 3.6%. That would be a very strong rebound from the country’s 0.5% contraction in the first quarter. Looking ahead, the International Monetary Fund (IMF), a widely watched global think tank, released updated forecasts for economic growth last week that showed Europe outpacing the U.S. this year and next, and Japan's economy growing faster than the U.S. in 2023.

Overseas economic growth has been stronger than expected



Source: Charles Schwab, Bloomberg data as of 8/5/2022.

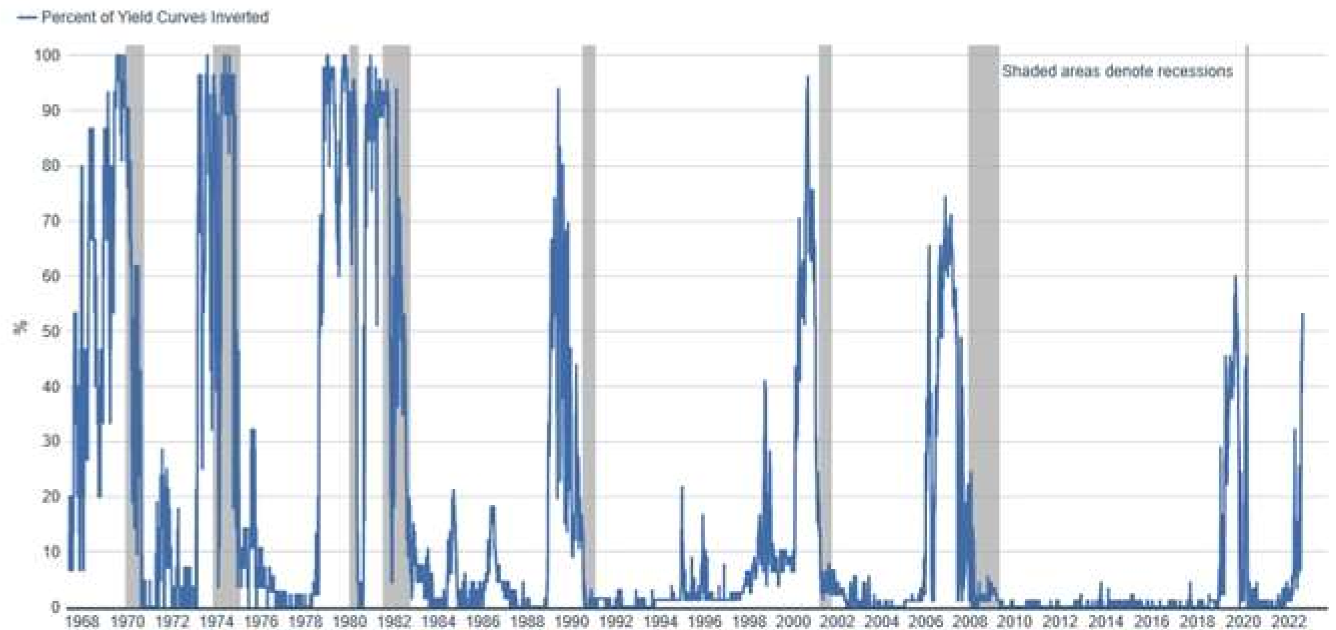
Forecasts contained herein are for illustrative purposes only, may be based upon proprietary research and are developed through analysis of historical public data. 2Q22 GDP for Japan is the Bloomberg consensus forecast (preliminary GDP data to be released on 8/14).

There are risks to growth for the coming quarters—particularly, the natural gas situation—and Europe's economy is still slowing. Europe's gas inventory continues to grow and is currently at 70% of capacity, which is normal for this time of year. However, the bloc must continue to build storage at least at a normal seasonal pace amid supply challenges.

An inverted U.S. Treasury yield curve hasn't just been a negative sign for the U.S. economy—historically, it has also augured global recessions. There are about 90

different U.S. Treasury yield spreads that compare every shorter maturity to longer active maturities. Rather than picking just one spread, like the two-year/10-year, looking at all of the spreads can tell us how much of the whole curve is inverted. As of early August, more than half of all yield curves had inverted.

Percentage of U.S. yield curves inverted is now over 50%



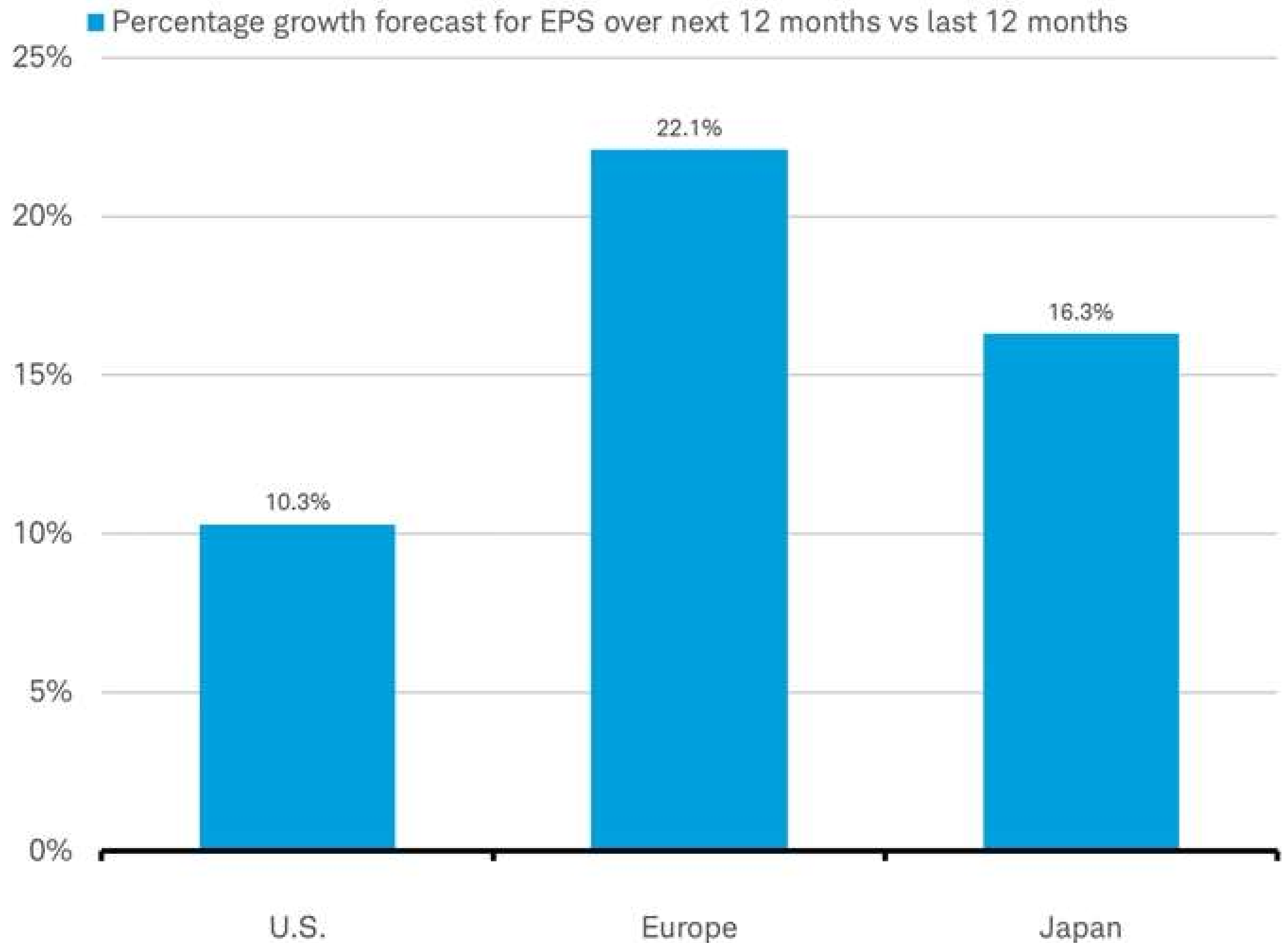
Source: Charles Schwab, Macrobond, US Department of Treasury data as of 8/8/2022.

U.S. Breakeven 10 Year (USGGBE10 Index) and U.S. Breakeven 5 Year (USGGBE05 Index). Daily data as of 7/13/2022 The breakeven rate is the difference between the TIPS rate and the comparable-maturity Treasury rate, and is used as a gauge for what market participants believe inflation will be five or 10 years in the future.

While the high and rising risk of an economic recession may not be news to investors, the yield curve could be signaling an earnings recession ahead. Although earnings held up well in the first half of the year, Wall Street analysts' forecasts continue to point to double-digit earnings growth over the next 12 months, which is very unusual during an economic recession. An earnings recession signaled by the yield curve could make market price-to-earnings ratios more vulnerable to a further pullback than they appear

now. High-dividend-paying stocks may continue to reward should the economy and earnings continue to slow.

Analysts expect double-digit earnings growth



Source: Charles Schwab, MSCI, FactSet data as of 8/5/2022.

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Alternatively, if earnings growth remains resilient as inflation begins to subside in the second half of the year with excess inventory leading to price cuts, then stocks may recover. This is likely especially for those with the brightest earnings growth prospects

and lowest price-to-earnings ratios, which tend to be more prevalent in the stock markets of Europe and Japan.

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