Schwab Market Perspective: No Stopping the Fed

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Higher interest rates lead to a stronger U.S. dollar, which is likely to add to global economic pressure and weigh on corporate profits.

Strong September job data showed that the U.S. economy is still running faster than the Federal Reserve would like, making it all but inevitable the central bank will continue to raise rates through the end of the year to curb inflation.

Higher rates don't affect the U.S. economy only—the pain spreads around the globe as other countries' currencies weaken against the U.S. dollar. The Fed's aggressive rate hikes have already made markets more volatile, and investors are concerned the U.S. central bank could lead the global economy into recession. However, market volatility on its own is unlikely to deter the Fed. Signs of global financial instability could lead the central bank to enact smaller rate increases in the months ahead, but we don't see the campaign halting before early next year.

Meanwhile, this month's announcement by OPEC+ members that they will curb oil production may not have as big an impact on oil prices and global inflation as some investors fear, for reasons we explain below. However, oil prices could still face pressure from sanctions against Russia as a result of its war in Ukraine.

U.S. stocks and economy: Pushing against headwinds

The Fed has raised its benchmark lending rate by three percentage points so far this year, but you wouldn't know that from the burgeoning jobs market. The economy added

a robust 263,000 jobs in September, while the unemployment rate fell to 3.5% (although that was largely due to a drop in labor force participation).

Such gains make it unlikely the Fed will back off its rate-hiking campaign anytime soon. Bank officials are concerned the tight labor market could drive inflation expectations, which can become a self-fulfilling prophecy.

Workers appear confident they can quit a job and easily find another one. As shown in the chart below, job leavers now account for nearly 16% of total unemployed individuals, the greatest share since April 1990.

Going somewhere?

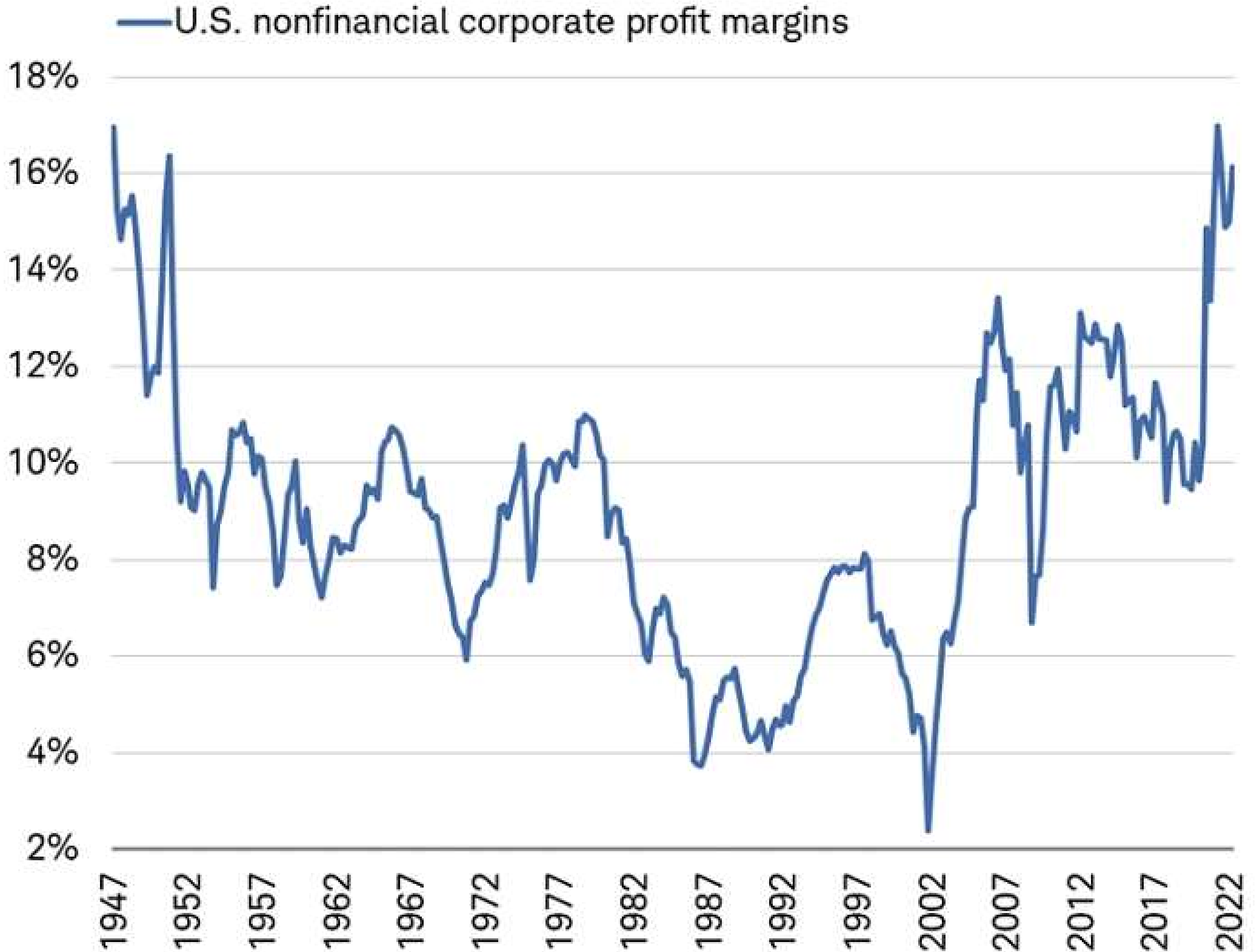
Source: Charles Schwab, Bureau of Labor Statistics, Bloomberg, as of 9/30/2022.

Wage growth as of 8/31/2022. Quits rate as of 7/31/2022. Atlanta Fed's Wage Growth Tracker is a measure of the nominal wage growth of individuals.

The Fed tends to see such confidence as evidence of a hot labor market, even though inflation expectations remain low and wage growth is easing. That is unwelcome news given how persistent inflation has been.

Resilient corporate profit margins are another potentially concerning sign, at least to anyone looking for the Fed to ease up. As shown in the chart below, nonfinancial profit margins are hovering near a historically strong 16%, as measured by the Bureau of Economic Analysis (which surveys a broader swath of companies than in the S&P 500).

Companies have got pricing power



Source: Charles Schwab, Bureau of Economic Analysis, Bloomberg, as of 6/30/2022.

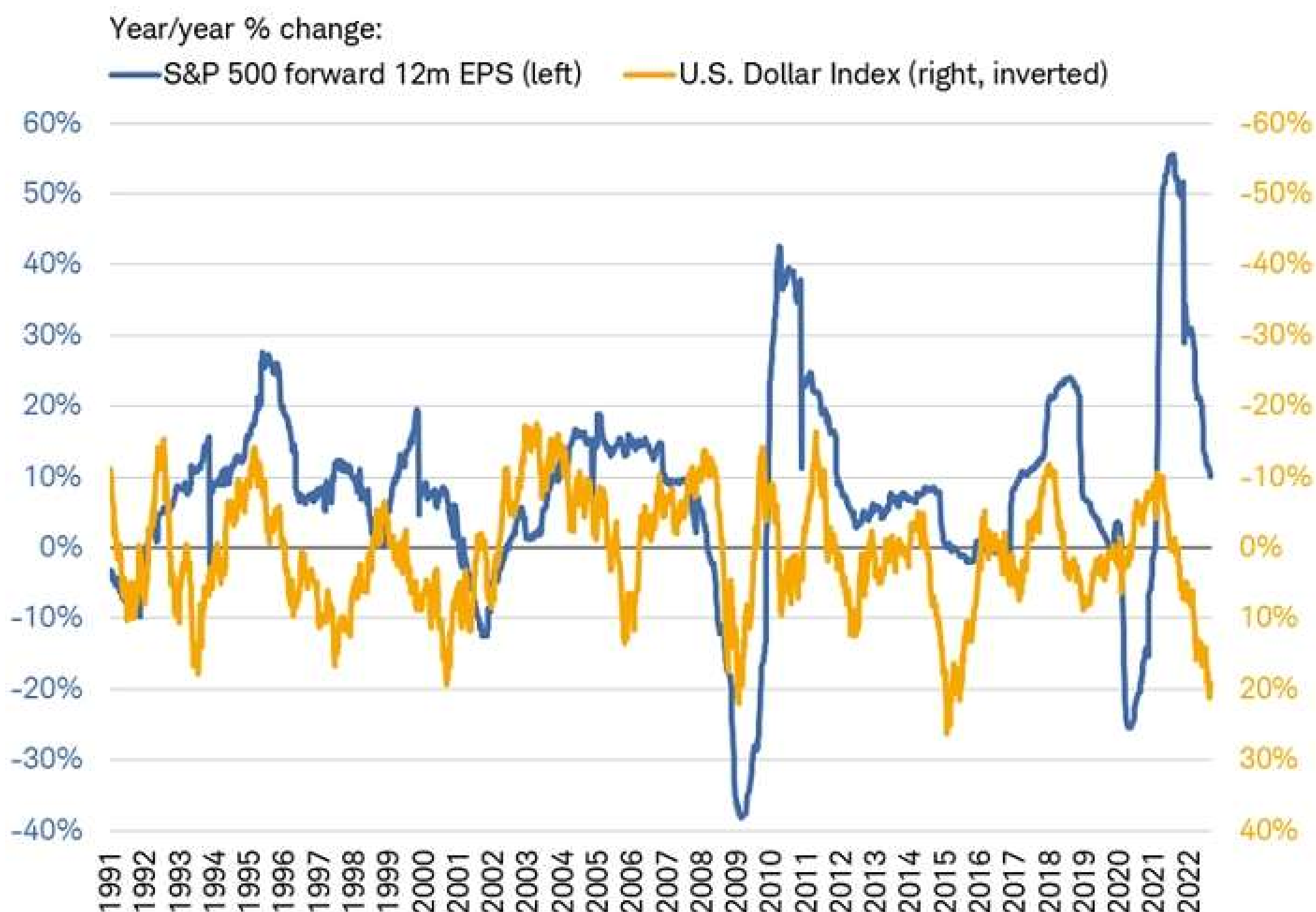
Past performance is no guarantee of future results.

Keep in mind that the Energy sector accounts for a considerable portion of the recent jump in earnings. Petroleum and coal industry profits rose 340% in the second quarter alone, driven by the epic surge in oil prices this year. As investors have learned, such gains have contributed to inflationary pressures.

If the aggressive rise in interest rates helps drive down energy prices, we might expect the headline profitability numbers to fall.

Another headwind for companies' bottom lines is the U.S. dollar's persistent, strong rally this year. As shown in the chart below, the dollar has surged by more than 20% over the past year, the fastest annual gain since 2015 and, before that, the 2008-2009 global financial crisis.

A strong dollar has tended to coincide with lower earnings expectations



Source: Charles Schwab, Bloomberg, as of 10/7/2022.

Forward earnings estimates compiled by Bloomberg. Dollar index used is the DXY Index. **Past performance is no guarantee of future results.**

An excessively strong dollar can cause an earnings recession—especially when the macroeconomic backdrop is overshadowed by the Fed's aggressive tightening policy,

pessimism among consumers and businesses, and a significant slowdown in leading economic indicators.

The strong dollar will probably hit earnings eventually. Foreign exchange difficulties often take a while to fully translate into weaker profits. That means companies could be looking at a difficult start to next year.

Fixed income: Pain is spreading globally

Fed Chair Jerome Powell has acknowledged that the central bank's fight against inflation will likely involve "pain for some households and businesses," alluding to the risk of recession and rising unemployment. However, the Fed's moves are also causing pain beyond U.S. borders.

The Fed is often referred to as the "central bank to the world" because its policies have a big influence on the global economy. Because the dollar is the world's reserve currency, U.S. interest rate changes ripple across the globe in the form of currency volatility.

Between its rate increases and the reduction of its bond holdings, the Fed's recent moves have sent the dollar to all-time highs versus the currencies of the United States' trading partners. A strong dollar helps the United States combat inflation by making imports more affordable—but it makes goods more expensive for the country's trading partners.

The dollar's value has risen sharply

Source: Bloomberg.

Bloomberg Dollar Spot Index (BBDXY Index). Daily data as of 10/10/2022**. Past performance is no guarantee of future results.**

To prevent their currencies falling too far, foreign central banks have been trying to keep pace with the Fed's rate hikes. That has created a global tightening cycle just as many countries are struggling with recession and energy price shocks.

Global yields have risen

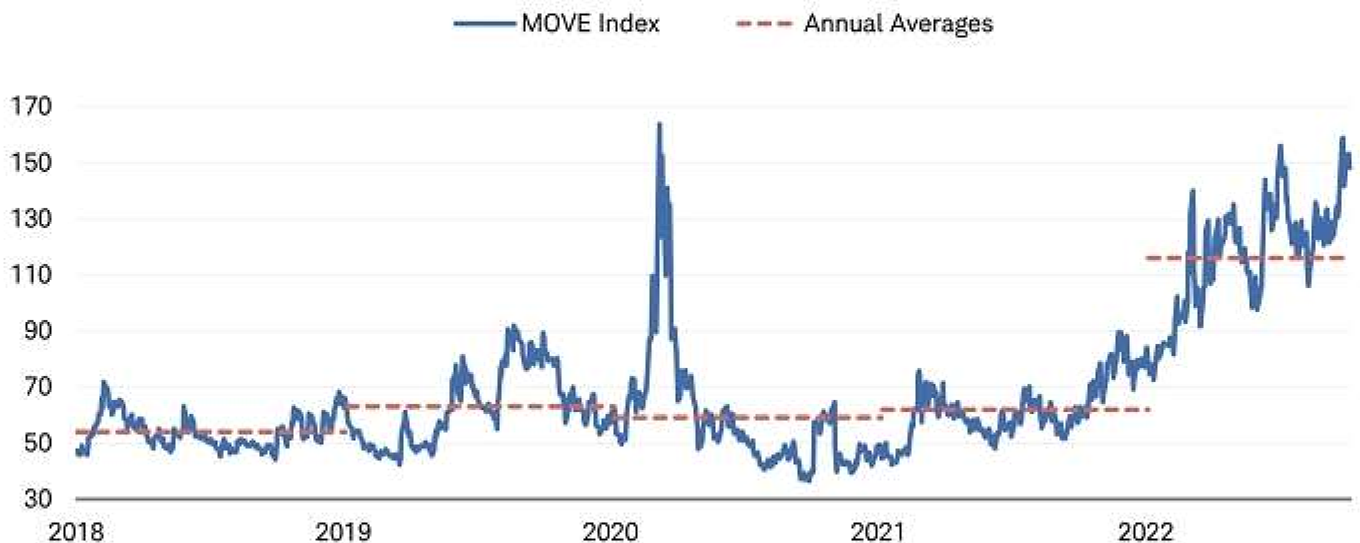
Source: Bloomberg.

U.S. (USGG10YR Index), Germany (GTDEM2Y Index), Italy (GTIT2Y Index), Greece (GTGRD2Y Index), U.K. (GTGBP2Y Index), Canada (GTCAD2Y Index). Daily data as of 10/10/2022. **Past performance is no guarantee of future results.**

The dollar's recent rise has been especially difficult for emerging-market countries, which tend to benefit most from global growth and/or have high levels of U.S. dollar-denominated debt. But even rich countries are struggling. Japan intervened in the currency market for the first time since 1998 in early October to prevent the yen from falling and destabilizing the central bank's control over bond yields. The Bank of England recently stepped in to buy its government bonds, and the European Central Bank is using its reserves to try to cap the rise in bond yields in some European Union countries.

To a large extent, the rate of change in the Fed's policy is contributing to the volatility in markets. As noted, the Fed has ratcheted up the federal funds rate—its base rate—by three percentage points since March. That rapid pace has left markets with little time to adjust and re-set expectations. The Treasury market hasn't been this volatile since March 2020.

Treasury market volatility nearing the March 2020 high



Source: Bloomberg. Merrill Option Volatility Estimate (MOVE INDEX). Daily data as of 10/7/2022.

Notes: Merrill Option Volatility Estimate (MOVE) is a yield curve weighted index of the normalized implied volatility on 1-month Treasury options. *2022 YTD average as of 10/5/2022.

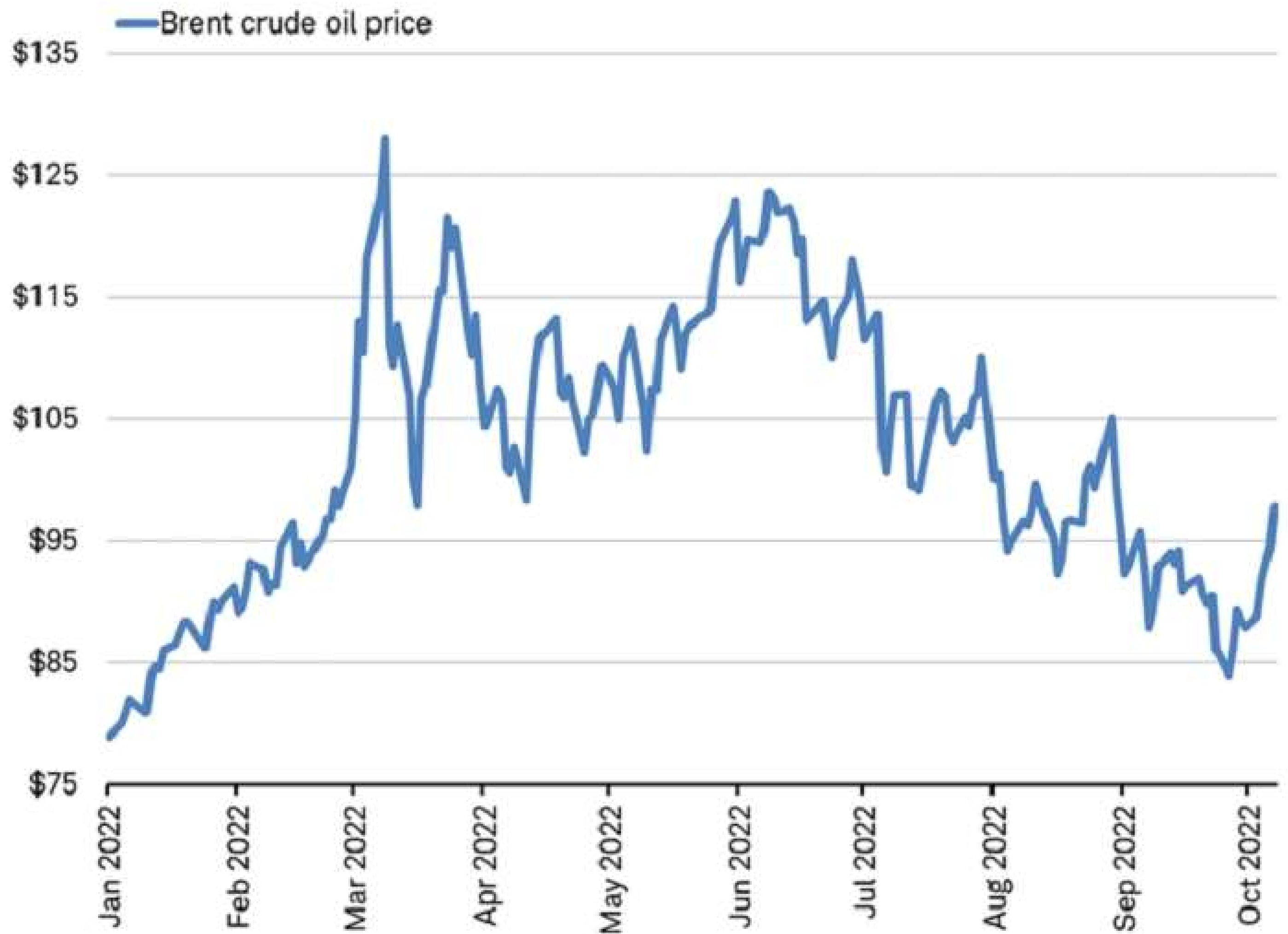
With the International Monetary Fund and World Bank holding their annual meeting (it ends October 16), it's likely foreign central banks will express concern about the Fed's aggressive policy approach. For now, the Fed is likely to resist calls to alter its policy. That probably will keep volatility high. However, we expect the Fed will need to slow the pace of its rate hikes in the next few months as global recessionary forces spill back into the U.S. economy and financial instability rises.

Global stocks and economy: OPEC and inflation

The 24 members of OPEC+ agreed on October 5 to cut their oil production target by 2 million barrels per day (mbpd) starting in November 2022 through December 2023, the largest production cut since the COVID-19 lockdowns of April 2020. The announcement raised concerns about energy-led global inflationary pressure at time when inflation is already the highest in decades. After the announcement, the price for Brent crude oil, the global crude oil benchmark, hit $98, though it is still well off the peaks of over $120 during the spring and summer.

However, the impact on global inflation may be far less than some fear for two reasons: OPEC production changes haven't led trends in oil prices and the actual cuts may be far less than those announced.

Oil prices are still well below their 2022 peak



Source: Charles Schwab, Bloomberg data as of 10/6/2022.

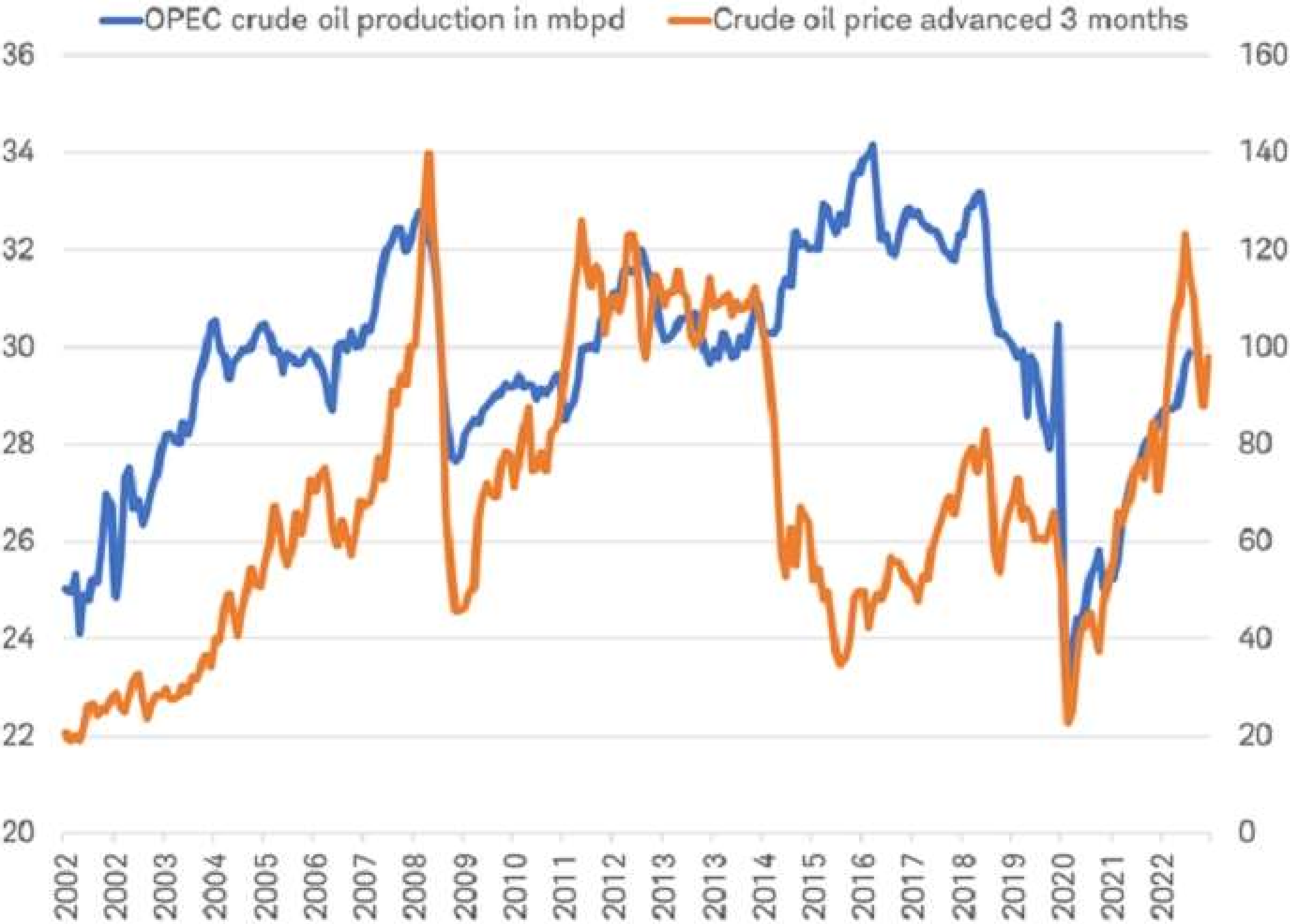
Past performance is no guarantee of future results.

Historically, OPEC hasn't driven oil prices—it has followed them, as you can see in the chart below. OPEC output tends to lag changes in oil prices by about three months, meaning the cartel tends to cut oil production after prices fall when demand weakens, and increase it after prices are already rising when demand improves.

And demand for oil has been weakening. In fact, the International Energy Agency's September Oil Market Report projected that oil markets would be oversupplied by 1 mbpd in the second half of 2022.

The announced cuts acknowledge that weakening, and may not signal a determined attempt to push up prices in a tight oil market. As a result, the OPEC cuts aren't likely to be a meaningful driver of global inflation or the economy, but could instead serve as a lagging indicator of the slowing demand for oil as the global economy weakens.

Oil prices and OPEC production



Source: Charles Schwab, Bloomberg data as of 10/8/2022.

Chart shows history of 13-member OPEC production. A larger group called OPEC+ was formed in late 2016 to have more control on the global crude oil market.

It is also important to recognize that OPEC production quotas and actual production aren't the same thing. The announced cut refers to a 2 mbpd drop in the OPEC+ production ceiling, taking it from 43.9 mbpd to 41.9 mbpd. (The cut on its own represents just 1.5% of the global oil supply.) However, some OPEC+ countries are already struggling to hit their current production targets. In September, OPEC+ fell short of its target by about 1.3 mbpd.

Saudi Arabia's energy minister has already said the actual cuts would be around 1.1 mbpd to 1.2 mbpd. These estimates are imprecise, especially because it is unclear how much oil Russia is currently exporting.

Whatever the actual number turns out to be, it's likely to be less than 1% of global oil supply. Again, since oil demand has already shrunk, it is unlikely OPEC+'s plans will add significantly to inflation pressures.

That's not to say there aren't other risks lurking in oil prices. Starting December 5, any buyers of Russian oil using insurance, finance, or shipping provided by companies in Group of Seven countries (G7) or the European Union will be required to abide by a price cap dictated by the G7. By cutting current output, Saudi Arabia may just be reserving some production if Russian oil exports plunge after the G7 price cap goes into effect.

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