

SCHWAB GOVERNMENT POLICY:

Inflation Peaking but Pain Won't End

November 17, 2022

MIKE TOWNSEND: If it feels like the last couple of weeks have been particularly dizzying, well, they have. Just think of some of the things that have been moving the markets, here and abroad:

The latest inflation report came in better than expected—and produced the best one-day gain in the markets in more than two and a half years.

The jobs report showed surprising resilience as hiring remains strong. Yet days later major tech companies announced tens of thousands of workers would be laid off.

President Joe Biden and President Xi Jinping of China met face-to-face for the first time since Biden took office.

North Korea tested dozens of missiles, including one that crashed into the waters just 35 miles from South Korea, increasing tensions in the region.

The cryptocurrency sector faced its biggest crisis yet with the stunning implosion of FTX, one of the largest cryptocurrency exchanges.

And, oh by the way, there was this little midterm election thing that played out in a way almost no one saw coming.

Welcome to *WashingtonWise*, a podcast for investors from Charles Schwab. I'm your host, Mike Townsend, and on this show, our goal is to cut through the noise and confusion of the nation's capital and help investors figure out what's really worth paying attention to.

Coming up in just a few minutes, I'm going to talk with Kevin Gordon, a senior investment research analyst at the Schwab Center for Financial Research, about how to make sense of this deluge of information that's impacting the markets and investors.

But first, let me share a couple of my thoughts on the election and on what to expect as Congress returns to Washington facing some key decision points before the end of the year.

With regard to the midterms, here are three quick takeaways.

First, I think this was another reminder that, when it comes to forecasting elections, no one knows anything. It's clear that polling was a bit off, that the assumptions and narratives that were being fueled by the media were off. Midterm elections are almost always terrible for the president's party—but this time Democrats did much better than history indicated they would do. And it seems what voters wanted was some sense of normalcy and status quo. Pending the outcome of the December 6 runoff election for

the Senate seat in Georgia, this is the first time since 1914 that not a single incumbent senator lost re-election. And while Republicans appear to have gained the majority in the House—no final call has been made as I record this—they are likely to have the narrowest majority since 1932. It was a change election that had hardly any change.

Second, it's one of the oldest clichés in politics, but candidates matter. It's clear that there were many candidates, particularly in some prominent Senate and governor races, who were able to win primaries but then struggled to appeal to a wider range of voters in the general election.

And finally, I think the biggest takeaway is that the next two years are likely to see gridlock in Washington, particularly if we end up with a split Congress, as it looks like we will. It's going to be very hard to find areas of compromise where the two parties can work together. I don't think we'll see much major legislation coming out of Congress in 2023.

And that may be good—it's often said that the markets prefer gridlock in Washington. We'll see, because that's what they're likely to get.

And here's one more post-election tidbit that should make investors happy: The S&P 500® has risen in the 365 days following every midterm election since 1950. The average gain has been more than 18%! Of course, past performance is no guarantee of future results—but that's a trend I think we would all support continuing.

Finally, while we're still sorting out the final details of the election of the next Congress, the current Congress is back to work. Lawmakers returned to Washington this week, and they'll be in session through mid-December. Since we're doing things in threes on today's podcast, here are three things for investors to watch for.

First, the key date is December 16. That's the deadline when current funding for government operations expires. Congress will need to either pass all the appropriations bills that fund every government agency and every federal program by then or pass another temporary extension of funding to avert a government shutdown. I don't anticipate a shutdown, but the path to avoiding it is likely to take a few twists and turns before getting resolved next month.

Second, we're continuing to keep an eye on a bill that would boost retirement savings. That still looks like it has a good chance of passing Congress sometime in early to mid-December. The bill would increase the age at which individuals need to start taking required minimum distributions from their retirement accounts, allow people approaching retirement age to save more, and take a number of steps to strengthen employer-sponsored retirement plans like 401(k)s.

And third, and this is one the market really cares about, there are some serious discussions about Congress possibly taking a vote to increase or suspend the debt ceiling before the end of the year. This is an issue that's looming in 2023, and volatility in the markets traditionally spikes when there is uncertainty about when and whether Congress is going to raise the debt limit.

Several prominent Democrats—including House Speaker Nancy Pelosi, Senate Majority Leader Chuck Schumer, and Treasury Secretary Janet Yellen—have publicly advocated

for Congress to deal with the debt ceiling now, while Democrats still have the majority in both chambers, rather than waiting for a fight next year when Republicans likely have control of the House. This idea is still germinating on Capitol Hill, and it may be that there is neither the time nor the political willpower to get it done before the holidays. But the fact that it's under discussion is pretty interesting. The markets would undoubtedly cheer a smooth and easy resolution to a looming crisis that has a history of rattling the markets.

On my Deeper Dive this week, I want to take a closer look at this unusual flurry of market-moving developments that have occurred over the last couple of weeks. We've had the release of the latest inflation numbers, the surprising jobs report, the stunning cryptocurrency collapse, and the midterm elections, among other developments. There is a lot to sort through, so I've asked Kevin Gordon, senior investment research manager here at Charles Schwab, to make a return visit to the podcast. Kevin, thanks so much for being here.

KEVIN GORDON: Thanks, Mike. Great to be back with you.

MIKE: Well, Kevin, last week's inflation report was better than expected, with the Consumer Price Index rising by a less-than-expected 0.4%, and headline inflation fell below 8%. That's the first time that's happened since February. Add to that the jobs report from a few days earlier, which showed that we added 261,000 jobs in October, fewer than September but still significantly above expectations. While that number was up more than expected, it was still the slowest pace since December of 2020. So are we seeing inflation peaking? What are the CPI and jobs reports telling us? Let's start with the CPI.

KEVIN: Sure, so if we're looking at inflation in year-over-year terms, it certainly, yes, looks like we've peaked. And that's both the nature of the math associated with the year-over-year calculation, but it's also indicative of the fact that we're starting to see some more demand destruction.

So if we look at October's report, in particular, it's definitely one of the better ones that we've seen in recent history. And the survey of economists and what the consensus was expecting was a monthly gain of 0.6%, and as you mentioned, the gain from the prior month was 0.4%. And if you go down to the core level, which excludes food and energy, because of their volatility, and is ultimately what the Fed is focused on, economists were expecting a 0.5% gain, and we instead saw a 0.3% gain. And you know, with any economic data, especially these days, we always have to take a look at what's going on under the surface and see what trends are forming. And, to me, one of the most notable trends, which has been in place for a while now, was the significant weakening in goods inflation and then the persistent stickiness in services inflation, specifically at that core level, which, again, excludes food and energy. And this is consistent with the way in which the economy has been emerging from the pandemic. We've seen consumers definitely finished spending most of their income on goods. And even though services have become more expensive, they're still opting to devote a good share of spending to that area. But, you know, the concern from the perspective of the Fed is that services inflation, which is a large chunk of indexes like the CPI, is keeping overall inflation at a much higher level, and the Fed is actively trying to combat

that, and we're only starting to see hints of it working now. So I'll give you a couple of examples.

If you look at medical care services, those prices fell by 0.6% in October, car leases fell by 0.5%, and then we also saw hospital services prices fall by 0.2%. On the other hand, the largest driver of services prices, which are shelter costs, continued to move higher in October. So shelter increased by 0.8%, and that was driven decisively by a 4.9% jump in hotel prices. That's probably worrisome from the standpoint of the Fed because it signals that consumers continue to spend money on travel and anything travel-related.

But on the goods side, the good news is that early pandemic-related inflation drivers are no longer keeping inflation elevated. So a couple of examples—used car, apparel, transportation-related goods prices, all of those are seeing a significant deterioration in growth, and that's bad for companies' margins, which I'll touch on later, but it's ultimately good for the consumer.

And back to one of the blemishes, though, that I do want to point out. It's the fact that inflation breadth has not improved much. And by that, I mean that when you look at the number of components within something like CPI that are seeing faster increases in the near term, so, say, over the past three months relative to the long-term, so, say, over the past year, it's still significantly elevated, and that needs to fall, I think, in order for us to say that we're seeing more progress on the inflation front.

MIKE: Well, that's a really helpful examination of what's under the hood. I think part of what makes this economic situation so unusual is that different parts of the economy are not necessarily acting in lockstep with each other. So I think it's good to look more closely at where there's relative weakness and relative strength inside the numbers.

So let's switch to the 'jobs' numbers. While the report still looks strong, there were major layoffs after it came out. Twitter announced 9,000 layoffs, half the company; Meta cut 13%, or 11,000 jobs; and this week, Amazon just announced 10,000 layoffs. If these recent layoffs are indicative of more to come throughout the workforce, then I guess the Fed is getting what it wants, right? How do you see this?

KEVIN: Yeah, so on the labor market, a theme that Liz Ann Sonders and I have been highlighting for much of this year is this difference that you're seeing between perceived strength at the headline level and then cracks underneath the surface. So I'll start with the headline level.

Labor market strength, it appears to be there. So as you mentioned, according to the Non-Farm Payroll Report, we added 261,000 jobs in October. But if you look at something like the Household Survey, which is a different metric than nonfarm payrolls, that fell by 328,000, and that's the third month this year in which both of those surveys have seen that kind of divergence. And I think it's really important to note the difference between these two reports. So the household survey includes workers that work on farms or gig economy workers and others that are not included in the nonfarm payroll count. And, importantly, in that household survey, individuals are only counted once, even if they hold more than one job. Whereas in the nonfarm payroll count, when people hold multiple jobs, each payroll that they're on is counted as a job. So that can really change and distort the number. And it essentially means that the nonfarm payroll

survey at certain points in the economic cycle, and, importantly, at turning points in the economic cycle, can either overstate or understate the number of jobs created.

So if we just look at the past seven months, for example, nonfarm payrolls have increased by nearly two and a half million, while the household survey has increased by only 150,000. And I mentioned that specific statistic because at turning points in the economic cycle, the household survey actually tends to lead nonfarm payrolls. And that would just mean that given those stats that I just mentioned, the spread between that nearly two and a half million and the 150,000, that would mean that employment is likely set to weaken from here.

And the other blemishes worth pointing out within the labor market are a rolling over in the number of hours worked, softening wage growth, an uptick in the number of multiple job holders, an increase in part-time employment relative to full-time employment. That is, unfortunately, a clear sign that consumers are getting increasingly stressed, given they have to take on more jobs. And I know that softer wage growth is ultimately what the Fed is looking for because they want to see that in order to bring inflation down. But the rub is that combined with hours worked, average weekly pay is actually falling, and at some point, that will not only be disinflationary, but it will also be recessionary if it continues. Less income growth or really no income at all leads to less spending that leads to weaker revenues, and that, ultimately, leads to less employment. So it starts to become a cycle that feeds on itself.

MIKE: Well, we've talked about the jobs report, we've talking about the inflation report, but there's always been kind of a three-way relationship between inflation, jobs, and monetary policy. Is that relationship changing, or is this just such a unique set of circumstances that we're living in right now?

KEVIN: Well, there are myriad ways in which this current cycle is unique. So I think applying history to this environment has proven to be a pretty treacherous exercise. But I will say it's clear that the Fed seems to be single-mandate focused these days, with that focus clearly being inflation. That's paramount, even relative to the health of the labor market. And the reason for this is that the Fed is battling inflation that hasn't been around for four decades. Not to mention the fact that in a normal cycle, the Fed will get ahead of the inflation issue by raising rates early in an attempt to combat the coming inflation. Then when inflation finally starts to peak and/or roll over, that's when rate hikes have already concluded, which, of course, has historically preceded a recession and then an eventual cutting cycle.

Today, a weaker labor market is essentially a feature, not a bug, of what the Fed is doing. So Chair Powell and other Fed governors mention in almost every speech that they want more labor slack, mainly because tightness in the labor market is largely consistent with faster wage growth and then higher inflation. So their hope is that they can accomplish this through crushing job openings or the demand for labor while not raising the unemployment rate by a significant degree. And we just think that that's really tough to accomplish. Even though job openings are off their peak, we're far from saying mission accomplished, so the Fed probably has more work to do there.

But I just want to mention one thing with the job openings data, the JOLTS data that comes out every month, we take issue with serious reliance on it just because it likely overstates the number of openings, which means that the labor market is probably not as tight as Fed officials believe. But, you know, I always say this, whatever we or other investors think probably isn't all that important at the end of the day. It's really what the Fed is relying on most. And one of their data points that they do rely on most is the job openings data. And the bottom line is that while the Fed is definitely attuned to the risks of their policies as they pertain to the labor market, Chair Powell and the rest of the members, they've made it very clear that they see higher inflation as the larger risk. And that's one of the reasons they've been just relentless in both raising interest rates but also planning to keep them at an elevated level whenever they get to that end terminal rate because it was that stop-and-go rate hike/rate cut cycle in the 1970s that arguably let inflation get out of the bag in that era, and that's definitely not what this Fed wants. If a recession is necessary in suppressing that possibility, then they're more than willing to do that.

And I also think that it's worth mentioning that no two tightening cycles are the same. So we can look back at history, but that's just less reliable by the day, as I mentioned earlier, given the small sample size of rate-hiking cycles that we have, but also because of the unique circumstances that plague the world today. So we still have the war between Russia and Ukraine, we still have some sort of COVID-zero going on in China, we have a looming energy crisis in Europe, and then we've got the fastest global tightening cycle in history. And you add to that the fact that markets today are still hyper-reactionary to the inflation data, and that may present a problem for the Fed, evidenced by the market's response to the October CPI report. I just don't think that this is much of a new monetary policy, really, as it is a return to something that many investors just today have never seen before, because we became so used to a low-rate environment just for so long, and now that's changing. And when you throw in some of those supply side stress and geopolitical ruptures that I mentioned into the mix, you just have a materially different situation today than anything we've seen in the past couple of decades.

MIKE: Well, I want to pick up on a couple of points you just made, and one that interests me is the idea that the Fed is trying to avoid the 1970s-style mistakes that they may have made back then. So I guess that begs the question, how do you think the Fed is likely to respond to all of this in the current situation? Obviously, the FOMC has one more meeting before the end of the year. Do you anticipate that they'll start to ease? I don't think we're going to see a pivot to lowering rates any time soon, but at least a backing off on the pace of rate hikes?

KEVIN: Well, I have no better ability to guess what the Fed will do than anyone else. So I'll take my cues from the market and certain news sources, maybe like *The Wall Street Journal* because they've taken on the role of Fed whisperer these days.

But after the better-than-expected October CPI report, you saw expectations for an aggressive hike at the December meeting fall, unsurprisingly. I'm not yet in the camp that the Fed raises by 25 basis points instead of 50 basis points, but I also want to emphasize that we still have another jobs report and a CPI report before the next Fed

meeting in December. That is a ton of data for the governors to sift through. And on the inflation front, if November accelerates some of the trends that we saw in October, I think that definitely clears the way for the Fed to be less aggressive. But on the other hand, if we have a situation like this past July and August, in which inflation jumped higher and actually disproved the idea that prices were cooling throughout the summer, then I think that probably keeps the Fed in an aggressive position for now.

For the labor market, I still think that nominal income growth is probably increasing at an uncomfortable pace for the Fed. So by that, I mean if you look at hours worked and earnings and then the number of individuals employed and take all of those three factors, nominal wage growth today is still nearly 8% in year-over-year terms. And I know it's much weaker in inflation-adjusted terms, but spending habits and inflation expectations tend to be influenced heavily by nominal trends. So that just means that nominal income growth, not necessarily real income growth, likely has to come down further.

And the other thing I want to stress is that even if the Fed were to ease back to 50 basis points or 25 basis points worth of rate hikes, it's still hiking rates. So policy is not getting easy instead of restrictive; it's just getting relatively less restrictive. Plus, we're arguably just getting to the phase in which you're starting to feel the true effects of the Fed's tightening campaign. So the market's recent cheering of the inflation data and the presumed stepped down for the Fed, to me, is a little bit ironic, because by the time we start to see a material rolling over in inflation, it will probably be the same time that we're going to be feeling the economic hit from the series of 75-basis-points rate hikes that we've seen this year.

So, yes, the path of least resistance for inflation is likely down from here, but if it starts to recede quickly and outright crash, that would be, just as history has shown us, synonymous with a significant slowdown in economic growth or a recession. And we can't forget that inflation is a coincident economic indicator—it moves with economic growth.

MIKE: Well, Kevin, this idea that there's a big lag between when the Fed makes hikes in the rate and when we really feel that in the economy, that's something that's getting a lot of attention here in Washington. We've definitely seen a big uptick in the last few weeks in policymakers openly questioning whether the Fed knows what it's doing. And the criticism is really that the Fed is moving too quickly, without giving the economy time to react and adjust to higher rates before they're hiking the rate again. So we know that the Fed is laser focused on getting that inflation number down, seemingly to the exclusion of most everything else, but it feels sometimes like the Fed is more worried about doing too little to inflation than it is worried about overshooting. Is that fair?

KEVIN: So I try not to be a Fed basher because I really don't see much utility in that. And I've also noticed that most of the louder voices and critics in the broader investment community criticizing the Fed often don't offer a solution as to what the Fed should actually do. Did the Fed wait too long to raise interest rates? Sure. However, you know, I have a suspicion that people arguing that the Fed is being too aggressive today may also take issue or would have made the same argument that the Fed would have been choking off the economic recovery had rates gone up sometime in 2021. And to my

earlier point, and to what you've mentioned, Mike, I think the Fed has made it exceedingly clear, both in language and forecasts, that it's almost solely focused on the inflation issue today. So it's not really the labor market, it's not that it doesn't matter, it's just that the governors believe that the labor market is extremely tight. So allowing for more slack and more unemployment won't cause that much destruction.

But the problem that I have with that assumption is that it's incredibly difficult to just expect everything to be fine in the labor market after you raise interest rates by 375 basis points in just eight months' time. Plus, this is more on the technical side now, and in their forecasts, implicit in the Fed's own forecast for unemployment, is a recessionary-like move. So if you just look at their latest summary of economic projections, they expect the unemployment rate to rise to 4.4% in 2023. And in the long-term history of the unemployment rate, the average increase from its cycle trough, so the lowest point it gets to in a business cycle, to the start of the recession, the month that the recession starts, is just 0.3%. So the Fed is indirectly telling you right there that a recession is almost necessary in order to bring inflation down. And in a more direct fashion, this is on the language front, Chair Powell has used the word "pain" a lot in his press conferences in the context of households and businesses having to undergo further pain in the process of getting inflation down. So we've taken that just as a code word for a recession. And not only that, you've had other Fed members in various speeches throughout the year willingly admit that a recession might be necessary to get inflation back down.

So I don't agree with that possibility, especially given the fact that we're still facing some supply constraints relative to somewhat strong demand in certain areas, particularly services. So if supply isn't healing fast enough, the only way for us to get back to equilibrium is just to bring aggregate demand down faster. And I'm going to quote our chief fixed income strategist, Kathy Jones, here, and I'll say that inflation is ultimately a policy choice. If the Fed really wants inflation to come down, it will put policies in place that definitely bring it down.

MIKE: Well, that's a really great examination of exactly what the Fed is thinking, or I guess what we think they're thinking, and we'll see and learn more at that December meeting.

Well, I want to switch gears. Last week saw the spectacular collapse of another cryptocurrency business. While the number of investors impacted is relatively small, what do you make of the concerns that this could impact the equity markets?

KEVIN: Yeah, so there was some weakness across the equity market when the initial news of the collapse of FTX broke, but I'm not sure how much of it was directly tied to crypto, mostly because the next two days saw a relatively strong stock market rebound, while crypto continued to slide a little bit. But there's no question that stocks and cryptocurrencies this year have been tightly correlated. And if you actually look on a rolling 200-day basis, so a 200-day look-back, the correlation between daily moves in both the S&P 500 and then Bitcoin is still hovering around 0.6, which is essentially the highest that we've seen since Bitcoin has been around.

But I will caveat, the first rule of thumb with correlation is that it's not causation. So we can see that clearly, too, by, you know, looking at stocks and Bitcoin over the past week, and the fact that stocks have done a little bit better and maintained some strength, while cryptocurrencies have struggled in a relative sense.

So I think that if crypto continues to weaken, and the stock market doesn't flinch as much, that's ultimately a good thing for the broader financial system because it would at least signal to us and prove that the crypto industry isn't systemically important to traditional asset markets, so any collapse or further weakness wouldn't put us at material risk.

But the closest tie to the equity market with crypto is in the speculative names that rallied significantly with crypto over the past couple of years. So, you know, many of those, unsurprisingly, are meme stocks, and they led the rally on the day, actually, that we got that October CPI report. And I want to jump into some of the details because I do think this is important to look at with a closer lens. So on that day, the S&P 500 soared by 5½%. And then the NASDAQ surged even more by 7½%. But when you move down the quality spectrum, that's actually where you saw the strongest performance. So a group of the most heavily shorted stocks that we track jumped by 11%. There's another group of non-profitable tech stocks that increased by 15%. And then you saw several meme stocks jump by similar rates. That is hardly consistent with what's been doing well in the current bear market since January, and it's definitely not consistent with what we expect to continue to do well. So, essentially, it's looked like one massive short squeeze, where investors who were bearish on these segments of the market were just forced to pay up in order to cover their shorts because of that really large move that you saw on an intraday basis.

So, essentially, we wouldn't embrace any of those moves, and for fundamental reasons alone, I think investors should just consider where we're at in this cycle. So growth continues to slow. We've got the Fed actively raising interest rates from a now elevated level to an even more elevated level. And that doesn't benefit at all companies without earnings or no fundamentals at all. And this is highly reminiscent of the rally that we saw from mid-June to mid-August of this year, where several low-quality speculative parts of the market started to get a lift and actually lead the market higher. And that proved to be relatively short-lived.

So I wouldn't get distracted by moves in those areas today, because the upside, while it can be enticing, the downside could be twice as dangerous.

MIKE: Well, Kevin, we had another big development last week that tends to distract investors, and that's the mid-term elections. As I said earlier in the episode, overall, not a particularly good night for Republicans. They appear to have taken over the House, but by a much smaller margin than expected, and they failed to retake the Senate. As a result, I think we're looking at a pretty serious case of gridlock in Washington for the next two years, and the conventional wisdom seems to be that gridlock is good for the markets. So is that accurate? How is the market reacting to the mid-terms?

KEVIN: So I'm not a very big fan of subscribing to returns associated with the makeup of the presidency and Congress, mostly because I'm a big believer in the power of

business cycles and macro forces, not to mention the fact that we've had varying sample sizes of the split and makeup between the presidency and Congress.

But to your first question, it is accurate if we use the Dow Jones Industrial Average as our proxy for the equity market, given the longer history, the strongest performance when you go back to 1900 has been when we've had a Democratic president and a split Congress, so presumably, the situation right now. So the average inflation-adjusted return has been 8%.

What's interesting, though, is that before today, the only period in which that was the case was during the presidency of Barack Obama from 2010 to 2014. So, at first, you might argue that four years' worth of data is pretty solid, but we should also consider the fact that the stock market was well into a new bull market at that point. So the S&P 500 bottomed in March 2009, and inflation was actually in a down trend from 2011 to 2014. So that set us up for really strong real returns.

And it gets to a broader point that I just want to emphasize when it comes to both Washington and the stock market, you know, and it's perhaps conventional wisdom to think that the presidential and/or congressional policies will have a direct impact on markets, but that just really isn't always the case. And I want to use two examples to sort of paint this picture.

So example number one, if we look at the tax cuts that we got in 2017, on paper and in isolation, one would think that both corporate and individual tax cuts would be a boon for risk assets. There's implications for elevated confidence and probably implications for higher spending. But the reality is that the market in 2018 suffered from the implosion of the short-term volatility trade. We entered a heated trade war with China. We entered a form of a manufacturing recession, and then we got close to a bear market in the fourth quarter of 2018. And there was a lot of discussion around an impending recession.

Example number two, if you look at the presidential administration today, one would think that an increase on the focus of clean energy and ESG, which generally tends to be the domain of those in the Democratic camp, would be a relative negative for the traditional energy sector and any stocks in that sector. But both year-to-date and since January 2021, the energy sector is by far the best performing sector out of all 11 that we track. So as of last week, it's up 70% this year and 150% since last January. And there are multiple reasons for that outperformance, not least being the lift in commodity prices this year, courtesy of the war in Ukraine. And you may not necessarily attribute that at all to the current administration in power, but that's exactly my point. That macro force of Russia's invasion of Ukraine and the subsequent ripple effects in global energy markets has been strong enough to send energy stocks soaring and keep them at the top of the leaderboard.

MIKE: Well, Kevin, I really agree with your point about how the Washington impact on the market can be overstated. And I think when I speak to investors all over the country, I try to remind them not to get wrapped up in the emotions of elections and policy and politics, because I think, historically, it doesn't have that big of an impact on the markets,

and especially right now, when we have lots of other factors that are probably way more important that are weighing on the markets.

Well, Kevin, we've talked about several big issues, the market's perception about the economy and recent mini rally, what the Fed is doing and what it needs to be doing going forward, the elections. We, of course, have just a few weeks left in 2022, so given all this, is it time for investors to start making any changes to our thinking? After all, even with a bit of a rally, we're still in a bear market. On the other hand, if you use election day as the starting point, the market has been up for the one year after every mid-term election since 1950. So where do you see opportunities right now?

KEVIN: So our thinking around the stock market's likely outperformers moving forward hasn't really changed. And for the better part of the past year, what we've really been emphasizing are quality areas of the market, specifically, companies that have high-quality earnings profiles. So just as a couple of examples, that means that investors should still screen for companies that have a high return on invested capital, a high return on equity, positive earnings revisions, or strong forward profit margins, because with input costs still high, productivity growth still low, and then earnings growth falling, you have to look for areas that have been able to manage those stresses pretty well. And maybe unsurprisingly, there are fewer names out there today that have done so, which just means that the market has placed a premium on them. And that's been a way to play defense in the bear market this year.

And we think that continues, mostly because the path of least resistance still right now for earnings growth is likely downward. And tying that in with the broader market, you know, at this point, I still don't see enough convincing evidence that stocks are set to enjoy a longer-term durable rally. You know, we may have a strong year-end seasonal period at our back, but we also have to consider the state of the leading economic indicators, specifically, those that are housing- and manufacturing-related. Those traditionally lead economic growth and market performance the most, and they have not yet found a trough. Until that happens, and we get clarity on both the inflation and the labor backdrop, I don't think that we can firmly say that stocks are out of the woods yet.

And I will put, at this point, a plug in for our 2023 outlook, because we're going to go into a lot more detail with this and publish it in a few weeks' time.

MIKE: Yeah, listeners can find the 2023 outlook series from all of our Schwab experts beginning right after the Thanksgiving holiday.

Well, Kevin, as usual, you've done a great job at giving us some important context for how a lot of different recent developments are impacting the markets. Really appreciate your time today.

KEVIN: It was great to be back. Thanks so much, Mike.

MIKE: That's Kevin Gordon, Schwab's senior investment research manager. You can catch some of his work with Schwab's chief investment strategist, Liz Ann Sonders, at schwab.com/learn.

Well that's all for this week's episode of *WashingtonWise*. We are once again going to change up our schedule a bit because of the holiday week. So we'll be back with a new

episode on December 8. Take a moment now to follow the show in your listening app so you won't miss an episode. And if you like what you've heard, leave us a rating or a review—that really helps new listeners discover the show.

For important disclosures, see the show notes or schwab.com/washingtonwise, where you can also find a transcript.

I'm Mike Townsend, and this has been *WashingtonWise*, a podcast for investors. Happy Thanksgiving to all and keep investing wisely.