Charles Schwab

Market Perspective: Slowdown or Recession?

January 13, 2023 [Liz Ann SondersKathy JonesJeffrey Kleintop]

Although it's possible the Federal Reserve will guide the economy to a "soft landing," evidence has been pointing toward recession.

For almost a year now, the Federal Reserve has been trying to raise short-term interest rates just enough to bring down inflation without causing a recession—what Fed officials call an economic "soft landing." The economy's apparent strength in the face of such efforts would seem to suggest they're succeeding. However, appearances can be deceiving. In fact, recent data have been pointing toward recession.

The Fed has signaled it plans "hike and hold" rates at high levels to help make sure inflation recedes. But the market isn't buying it. In fact, it's already pricing in cuts to the federal funds rate target in the second half of 2023. Treasury bond prices have rallied. This mismatch in expectations—the Fed vs. the market—may drive volatility in the months ahead.

Looking abroad, emerging market (EM) stocks also have gotten off to a strong start thanks to China's sudden decision to end its COVID-19 lockdown. The MSCI EM index is now on the cusp of a bull market, having risen nearly 20% since the end of October.

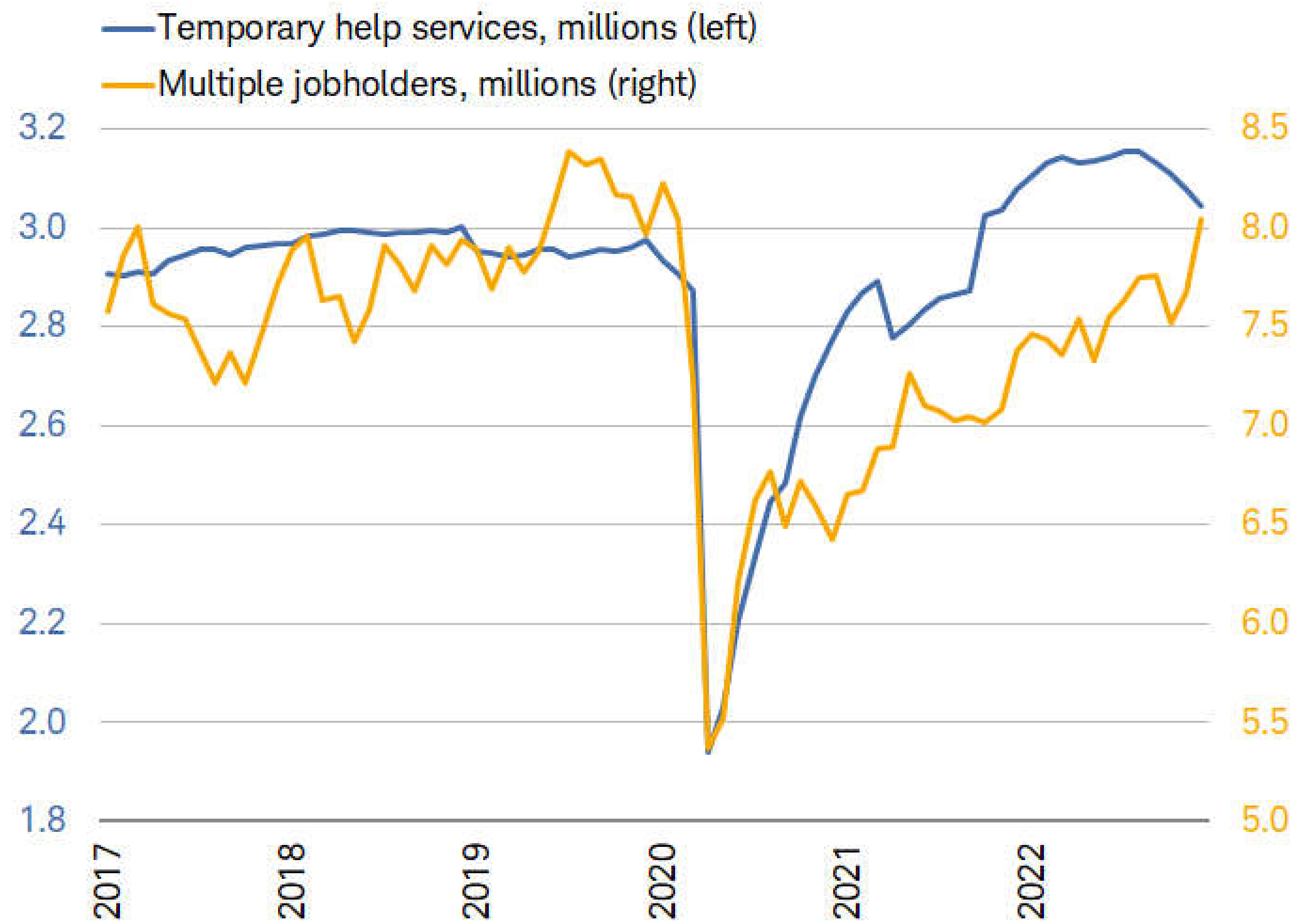
U.S. stocks and economy: Soft landing vs. recession

The U.S. economy ended 2022 on uneven footing. Some data—including weekly initial jobless claims, consumer spending, and the unemployment rate—suggest the economy is in relatively good shape. However, measures of manufacturing sentiment, employee hours worked, and business confidence aren't so reassuring.

Here's an example: The latest U.S. employment report showed the economy added a healthy 223,000 jobs in December. With the unemployment rate moving down to 3.5% (near its lowest level since the 1960s), the labor market appears tight. Despite softening wage growth, such robust job growth would seem to bolster the case for an economic soft landing.

Look closer, though, and the situation isn't so clear. Temporary-help employment—a key leading indicator of overall job growth—has fallen for five consecutive months, and the number of multiple jobholders has risen to its highest level since the COVID pandemic began in March 2020. Given weaker wage growth and still-high inflation, that suggests workers are taking on additional jobs to cope with difficult economic circumstances.

Workers have picked up multiple jobs

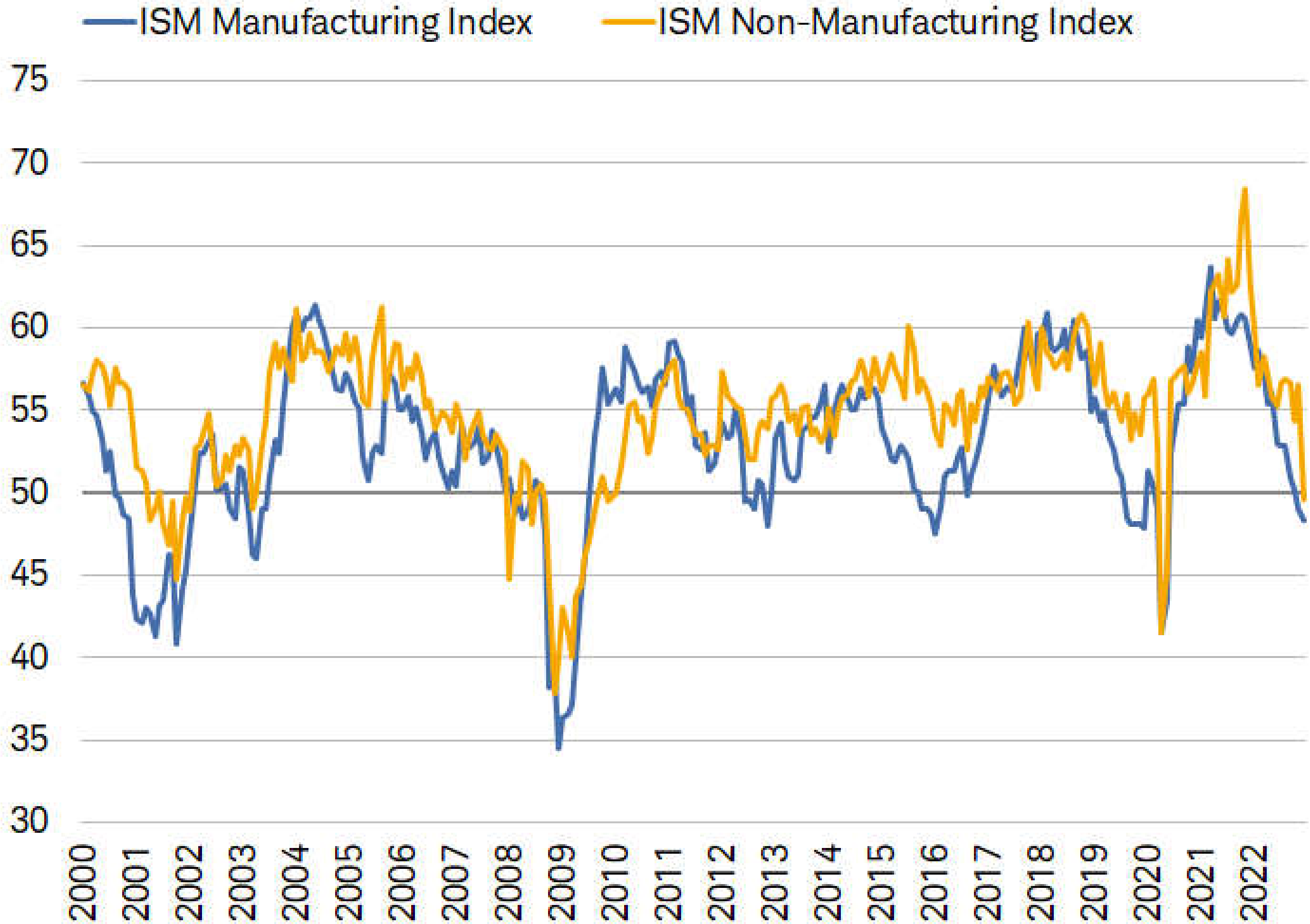


Source: Charles Schwab, Bureau of Labor Statistics, Bloomberg, as of 12/31/2022.

The Atlanta Fed Bank defines a "job stayer" as someone in the same occupation and industry as a year earlier, and with the same employer in each of the last three months. A "job switcher" includes everyone else (i.e., people in a different occupation or industry or employer).

Other evidence points more directly toward recession. For example, the Institute for Supply Management (ISM) purchasing manager indexes (PMIs) show deteriorating sentiment in both the manufacturing and services sectors. The services PMI fell sharply into contractionary territory in December, while the manufacturing PMI landed there in November.

Both services and manufacturing PMIs are in contraction

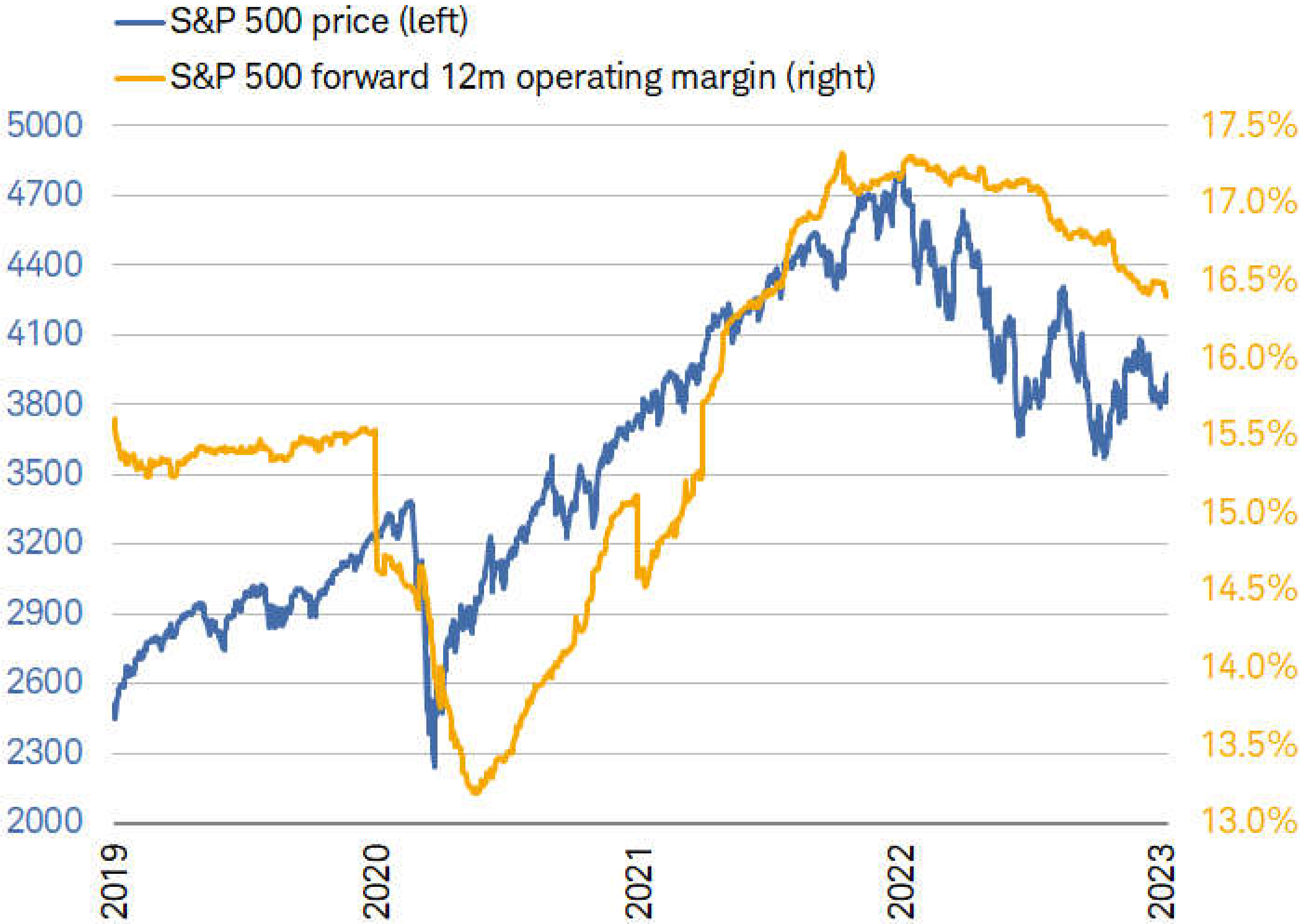


Source: Charles Schwab, Bureau of Labor Statistics, Bloomberg, as of 12/31/2022.

An index reading above 50 indicates expansion and below 50 indicates contraction in the manufacturing and services economy.

The deterioration in sentiment is perhaps understandable given the Fed's aggressive monetary policy tightening and worsening outlook for corporate profits as growth slows. At the same time, companies may still have more pricing power than the Fed would like. Many responded quickly to inflation by charging higher prices (due to soaring input costs) but have been slower to adjust pricing to the downside. As you can see below, the forward estimated operating margin for the S&P 500® index has fallen from its peak but is only back to mid-2021 levels—and is still higher than before the pandemic.

Margins have slimmed, but is it enough for the Fed?



Source: Charles Schwab, Bloomberg, as of 1/6/2023.

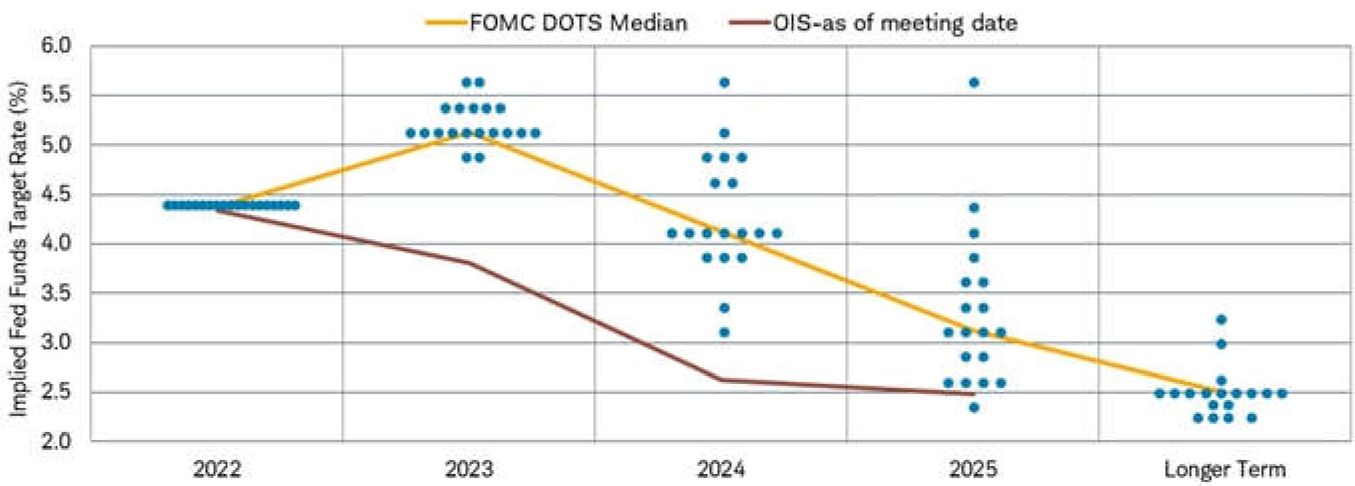
Past performance is no guarantee of future results.

Fixed income: A strong start to the year

After a dismal 2022, the bond market started 2023 with a bang, encouraged by signs of cooling inflation. Bond prices rallied sharply in the first week of the year, causing yields to fall. Longer-term yields led the decline, with 10-year and 30-year Treasury yields falling by roughly 30 basis points each (a basis point is one-hundredth of a percentage point, or 0.01%). Notably, the two-year Treasury yield also fell sharply as the markets' expectations about how high the Fed will hike rates shifted.

As a result of the rally, yields across the Treasury curve are now lower than the peak federal funds rate the Fed expects. According to the "dot plot" from the central bank's recent Summary of Economic Projections, the median estimate among Fed members is for a peak rate of 5% to 5.25%, with some members indicating that rates may peak at even higher levels.

The FOMC dot plot shows an expected peak rate of 5.25%



Source: Bloomberg, as of 12/14/2022.

The Federal Open Market Committee (FOMC) dot plot shows projections for the federal funds rate. Each dot represents the view of a Fed policy maker for the rate's target range at the end of each year shown. The yellow line shows the media "dot" or projection. The OIS (overnight indexed swap) as of meeting date reflects the market's expectation of the cost of repeated overnight unsecured lending over periods of up to two weeks or so.

Moreover, the Fed's forward guidance suggests it plans to "hike and hold" rates at high levels to help make sure inflation recedes. The market, however, is pricing in cuts in the federal funds rate in the second half of 2023. What does the gap between them mean? At some point, short-term interest rates will need to converge with the federal funds rate, as they historically have at the peak of the rate-hike cycle. The question is whether that convergence will be driven by market yields moving higher or by the Fed shifting its rate-hike expectations lower.

In the long run, we expect inflation to continue easing, allowing the Fed to ease back on its tightening plans. Prices for wholesale goods have largely fallen back to pre-pandemic levels, led by a steep drop in gasoline and natural gas prices. Also, as mentioned above, there are signs that the services sector is softening, with price increases waning and new orders and hiring falling. Because the service sector comprises the bulk of economic activity in the U.S., the shift to slower growth is significant.

A closer look at ISM services PMI reveals underlying weakness

Source: Institute for Supply Management, monthly data as of 12/31/2022.

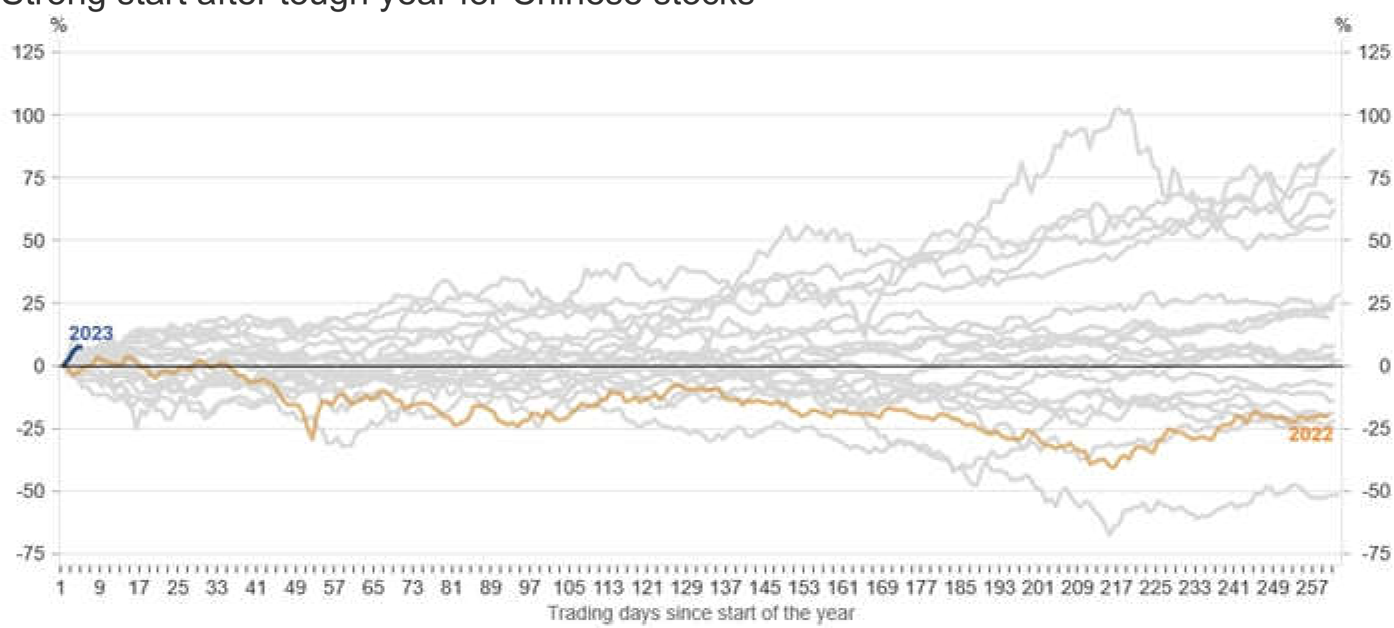
ISM Services PMI Report, ISM Services Composite (NAPMNMI Index), ISM Business New Orders (NAPMNNO Index), ISM Business Prices (NAPMNPRC Index), ISM Business Employment (NAPMNEMP Index). Note: An index reading above 50 indicates expansion and below 50 indicates contraction in the services economy.

Global stocks and economy: Strong start for emerging markets

Global stocks suffered a bear market in 2022 against a backdrop of war in Ukraine, central bank rate hikes, and slowing global growth. China's stock market woes were compounded by the heavy economic toll of the government's strict COVID lockdowns. The MSCI China Index had reached an 11-year low by October.

Then, in November, the government suddenly reversed course and reopened the country. China's stocks rebounded sharply despite the ensuing COVID outbreak. The MSCI China Index posted its strongest monthly gain in over 20 years, rising 36% in the last two months of 2022. The index has subsequently gained 8% in the first week of 2023, its best start to any year since 1995.

Strong start after tough year for Chinese stocks



Source: Charles Schwab, Macrobond, MSCI data as of 1/8/2023.

MSCI China index performance since start of year 1993-2023. **Past performance is no guarantee of future results.**

Coinciding with the Chinese Year of the Rabbit, which starts on January 22nd, economic activity may be multiplying. Many Chinese consumers were cautious when COVID infections initially surged in November but are now showing signs of growing confidence. Road congestion has been rebounding sharply in major cities (such as Beijing, in the chart below), reflecting a greater willingness to travel and spend.

Beijing traffic congestion index in 2022

Source: Charles Schwab, Macrobond, China Ministry of Transport as of 1/8/2023.

Signs of renewed Chinese demand are showing up elsewhere, as well. Taiwan's exports of integrated circuits to China rose 23% in December versus the previous month, even as its exports to other major destinations shrank. Steel and iron ore prices have risen 20%-30% since the end of October likely in anticipation of improving Chinese demand.

China's reopening has tended to be a boon for emerging market (EM) stocks so far this year. While the S&P 500 index was little changed between since October 31, 2022, and January 6, 2023, EM stocks are on the cusp of entering a bull market, having risen nearly 20% since October 31. Chinese companies account for about 33% of the MSCI

EM index, but the country casts a long shadow. China exerts significant economic influence over neighbors Taiwan and Korea, which make up an additional 13% and 11% of the index, respectively.

What investors can do now

Because we believe U.S. companies' profit margin growth probably will continue to shrink, we think investors who actively choose stocks should look for companies that have maintained—and still expect—strong profit margins. For most of the past year, the stocks of companies with proven profitability have commanded a premium. As the economy continues to slow, we don't see that leadership fading soon.

For fixed income investors, we continue to favor adding duration in bond portfolios at times when yields rise. If the Fed succeeds in calming inflation, locking in yields at these levels can be attractive for those looking for a steady income stream long-term. Bond ladders can be a useful tool to spread out maturities gradually. We also suggest staying in higher-credit-quality bonds, due to the potential for a downturn in the economy as the Fed tightens policy. Intermediate-term investment-grade corporate and municipal bonds still provide attractive yields compared to short-term investments.

And while it's possible that China's reopening could lead to volatility as markets swing between welcoming the country's growth and worrying about its potential effect on inflation—not to mention a surge in COVID cases—we continue to believe investors should consider an allocation to EM stocks for 2023. Stronger economic growth may lift earnings forecasts, while a more pro-growth policy orientation on the economy and housing may boost valuations.