Markets And Economy

Schwab Market Perspective: Half Full?

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As summer temperatures peak, inflation just won't completely cool down. The question is how much more the Federal Reserve should do about it.

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As summer heats up, it's hard to tell whether the beach ball is half full or half empty. Although a near-record-low unemployment rate underscores the strength of the economy, Federal Reserve officials keep pointing to the potential problems of a tight labor market and inflation that hasn't yet fallen back to the central bank's 2% target.

All this has the Fed poised to further tighten monetary policy—but given the rapid pace of past rate hikes, there's some concern that the Fed could overdo it, potentially causing a recession or triggering another round of problems in the banking sector.

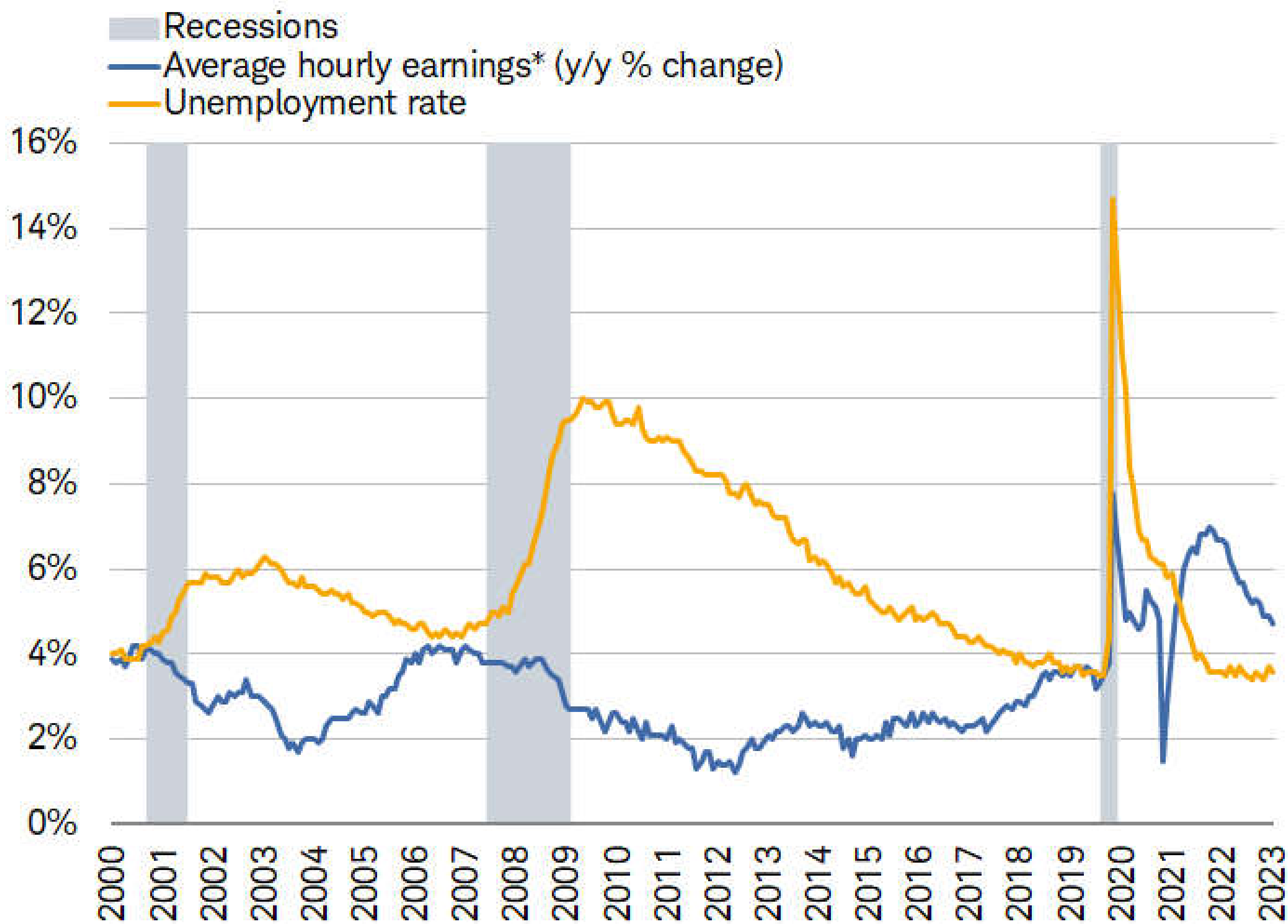
Meanwhile, there are signs of softening in global services and manufacturing activity, and China is on the cusp of deflation.

U.S. stocks and economy: Attempting to escape June gloom

As has been the case for a while, the labor market continues to look mixed, which has comforted both economic bulls and bears. On the upside, the economy has added an average of 244,000 jobs a month (measured over the past three months) and the unemployment rate is hovering near its lowest level on record. Yet the downside is twofold: Some cracks under the surface are still visible, and hotter wage growth is likely working against the Federal Reserve's progress in controlling inflation.

Weakness in key labor indicators, such as the contraction in temporary-help employment and the sluggish recovery in the household survey of employment (from which the unemployment rate is calculated) haven't confirmed the strength in metrics that garner more attention, such as the establishment survey of nonfarm payrolls. Those cracks are still visible at a time when wage growth continues to run hot, presenting a twofold issue for the labor market. Average hourly earnings growth (for nonsupervisory workers) continues to run well above 4% year over year. It remains to be seen whether wage growth can settle in a tamer range without a commensurate increase in the unemployment rate.

Labor market still looks tight



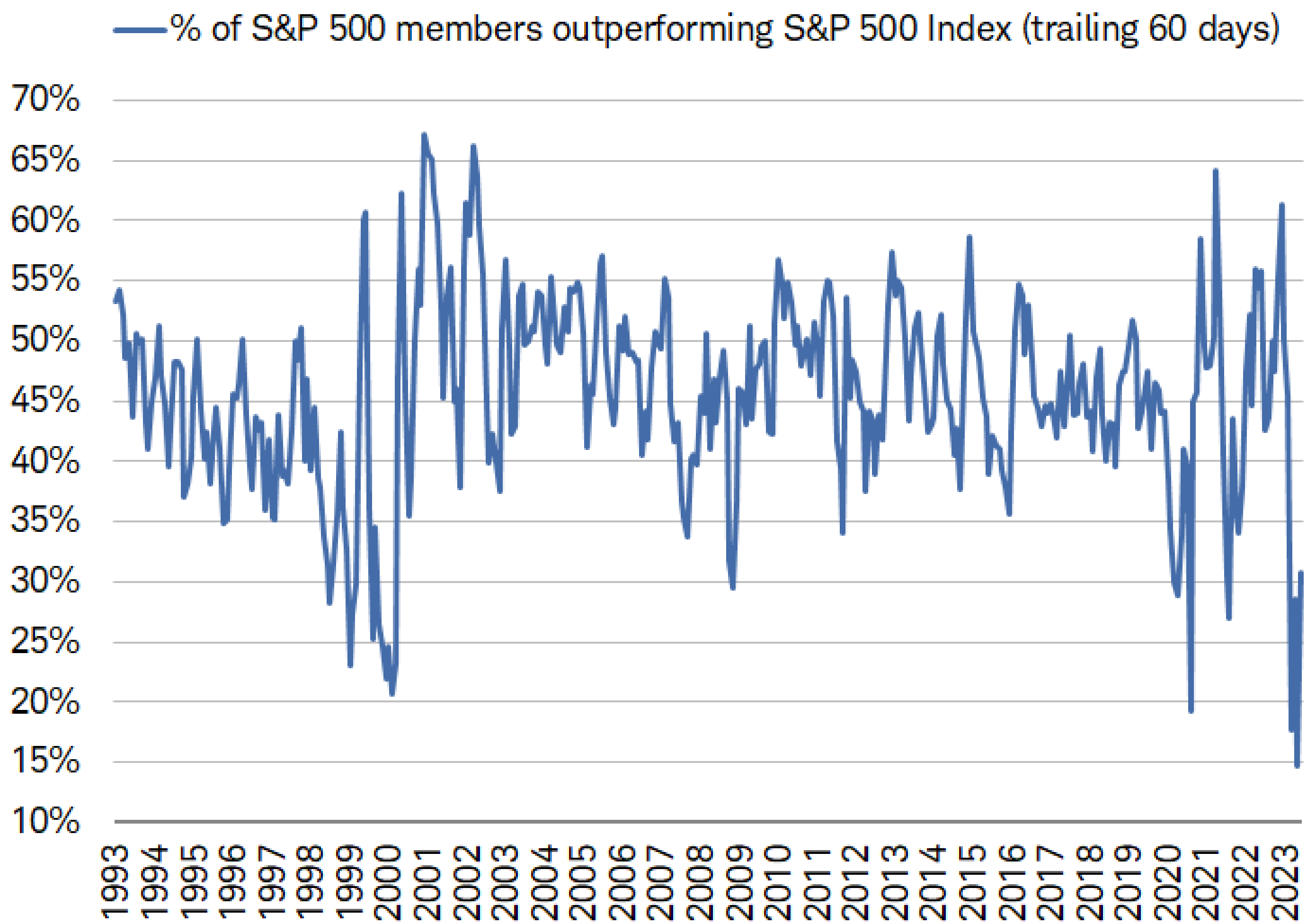
Source: Charles Schwab, Bloomberg, Bureau of Labor Statistics, as of 6/30/2023.

Participation rate as of 4/30/2023. Wage data as of 3/31/2023. The Atlanta Fed's Wage Growth reflects the median percent change in the hourly wage of individuals observed 12 months apart.

Fed officials consistently point to the potential issues of a tight labor market, especially in the context of inflation that hasn't yet fallen back to the central bank's 2% target. If wage and/or inflation metrics prove stubborn in their downward trend, it could force the Fed to be more aggressive with monetary policy.

That aggression doesn't guarantee weakness for the stock market, but tighter financial conditions likely would make it difficult for stocks to sustain a rally that has been built entirely on multiple expansion (that is, stocks' valuations have risen faster than their fundamental value—meaning earnings have not yet done much heavy lifting). Equities are already in a somewhat vulnerable space, with only about a third of the stocks in the S&P 500® index outperforming the broader index on a trailing 60-day basis as of June. While that is a notable improvement from an incredibly low 15% in May, it remains quite low relative to history.

Market breadth has improved since May

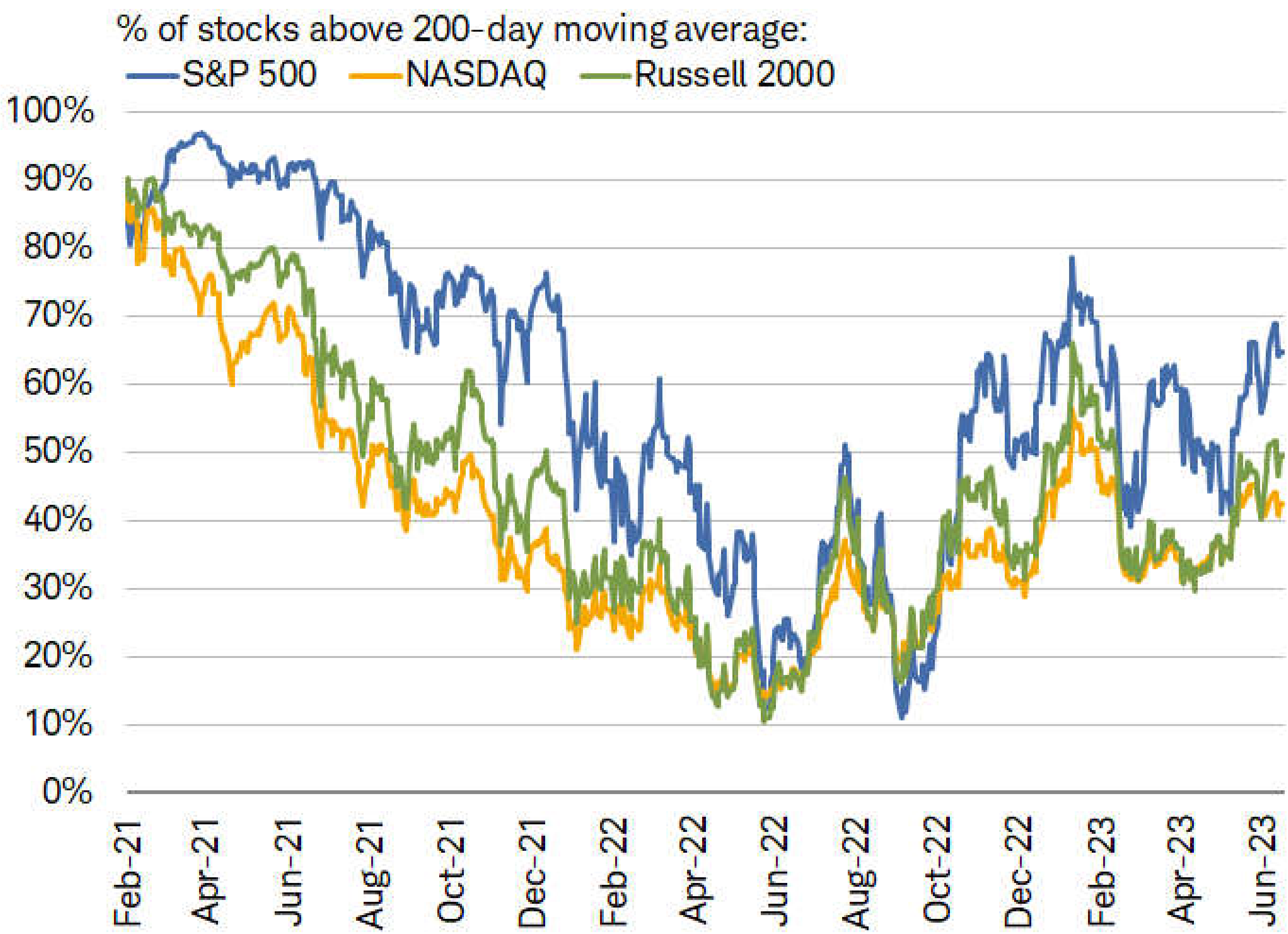


Source: Charles Schwab, Bloomberg, as of 6/30/2023.

Past performance is no guarantee of future results.

To be sure, the improvement in June was a welcome sign given the market's narrow leadership profile so far this year, with a handful of the largest stocks (by market capitalization) accounting for much of the rally. A continued broadening-out in participation for the "average stock" would bode well for future gains. Key to watch will be not only the S&P 500, but also indexes like the Nasdaq composite and Russell 2000, which capture a broader swath of the overall market. While all three have varying percentages of members trading above their 200-day moving averages, uptrends have been in place during the past couple of months. An eventual climb beyond the peaks reached earlier this year will be key in confirming stocks' rise—perhaps finally resolving the debate as to whether the market has entered a new bull market or is still mired in a drawn-out bear-market rally.

Market breadth trends have varied



Source: Charles Schwab, Bloomberg, as of 7/7/2023.

Indexes are unmanaged, do not incur management fees, costs and expenses and cannot be invested in directly. **Past performance is no guarantee of future results.**

Fixed income: Not quite there yet

Markets have been anticipating the end of the Federal Reserve's rate-hiking cycle for most of this year, but continue to be disappointed. Stubbornly high core inflation is keeping the Federal Reserve on track to continue tightening monetary policy. Rising short-term rates—and Fed signals that rates will stay higher for longer—have pulled up yields from the spring lows. However, the yield curve (the difference between short-term and longer-term Treasury yields) has stayed steeply inverted, as the rise in short-term rates outpaced the rise in long-term rates. An inverted yield curve indicates that the market expects yields to move lower over time, and is often an early warning sign of recession.

The divergence between the market's view and the Fed's view centers on different estimates of how tight monetary policy needs to be to bring inflation lower. Based on the Fed's June Summary of Economic Projections and recent comments, it appears that several Fed officials are concerned that policy isn't restrictive enough to bring inflation down to its 2% target and see the scope for more rate hikes. On the other hand, markets are looking out at the longer-term declining trend in inflation, which suggest that policy is working.

Of course, it's the Fed's decisions that count. Consequently, we expect a 25-basis-point rate hike by the Fed at its July 25-26 meeting, along with commentary indicating that policy will remain on hold or even tighten further this year.[1] That raises the likelihood of more potential upside in Treasury yields, but also increases the risk of an economic downturn.

Despite the Fed's concerns, there are several reasons to believe policy has tightened enough to bring inflation down longer term.

- Real Treasury yields of all maturities are that their highest levels since 2008. High real rates (that is, adjusted for inflation) discourage businesses from investing and consumers from spending, which is the point of tighter policy.

Real Treasury yields are at their highest levels in years

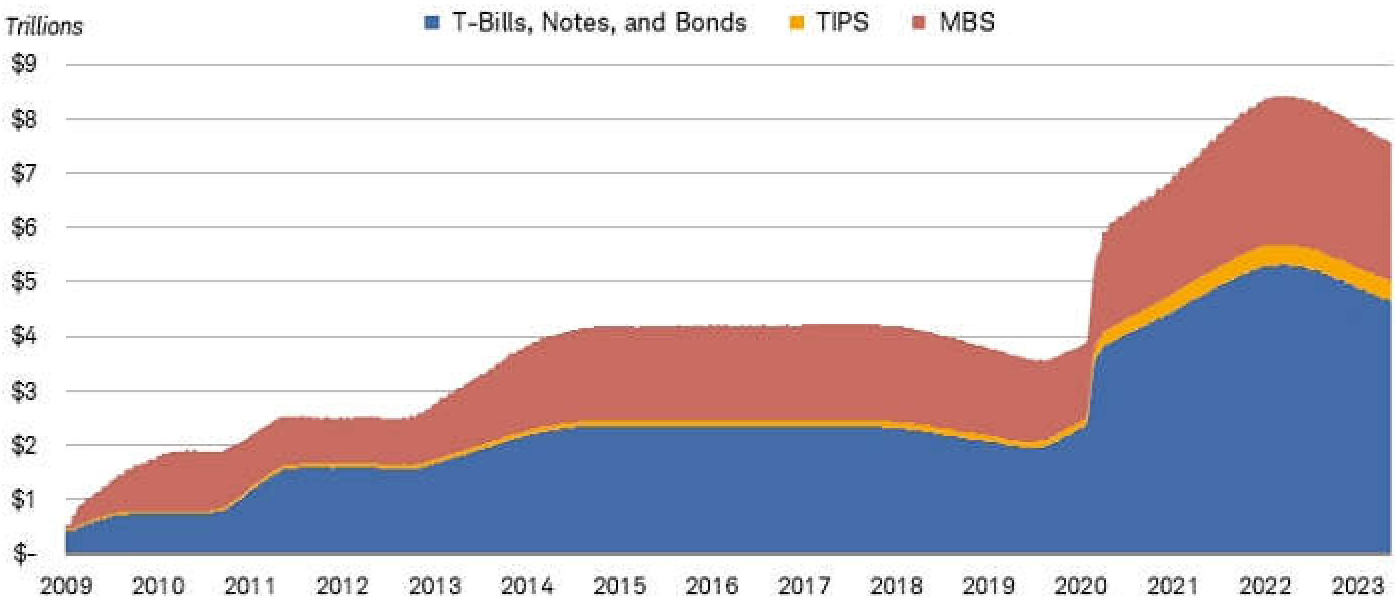
Source: Bloomberg, daily data as of 7/10/2023.

US Generic Govt TII 2 Yr (USGGT02Y INDEX), US Generic Govt TII 5 Yr (USGGT5Y Index), US Generic Govt TII 10 Yr (USGGT10Y Index), US Generic Govt TII 30 Yr

(USGGT30Y Index). A basis point (bps) is one-hundredth of 1 percentage point, or 0.01%. **Past performance is not guarantee of future results.**

- The Fed is still reducing its balance sheet by not reinvesting maturing bonds that it holds. A smaller balance sheet is designed to reduce the level of reserves in the banking system and add to the supply of bonds that need to be held by the public instead of the Fed. The total amount of securities held on the balance sheet has fallen by about $850 billion from its peak level. It is still high at about 32% of gross domestic product (GDP) but is on track to fall by $1.5 to $2 trillion by the end of 2024. The Fed estimates this process—known as quantitative tightening—is the equivalent of one to two 25-basis-point rate hikes.

The Fed's balance sheet has shrunk

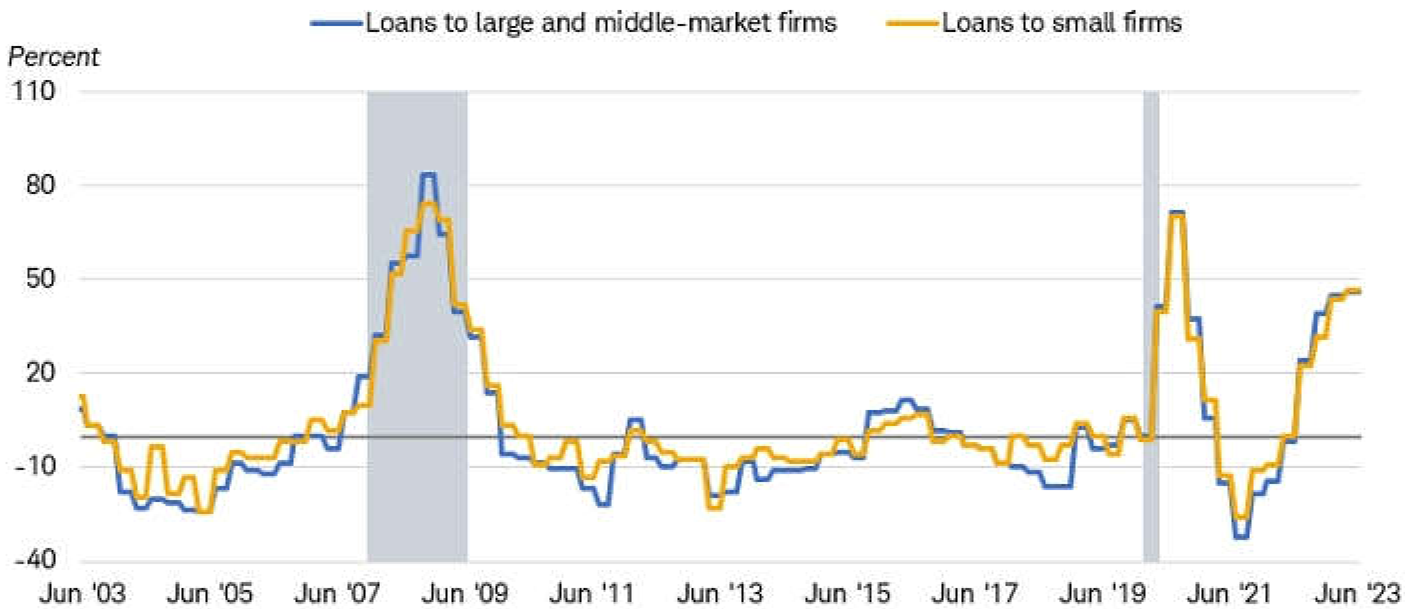


Source: Bloomberg, weekly data as of 7/05/2023.

Reserve Balance Wednesday Close for Treasury Bills, Treasury Notes, Treasury Bonds, Treasury Inflation Protected Securities, and Mortgage-Backed Securities.

- Banks continue to tighten lending standards, making it more difficult for businesses to obtain loans for operations, investment, and expansion.

Bank lending standards have tightened

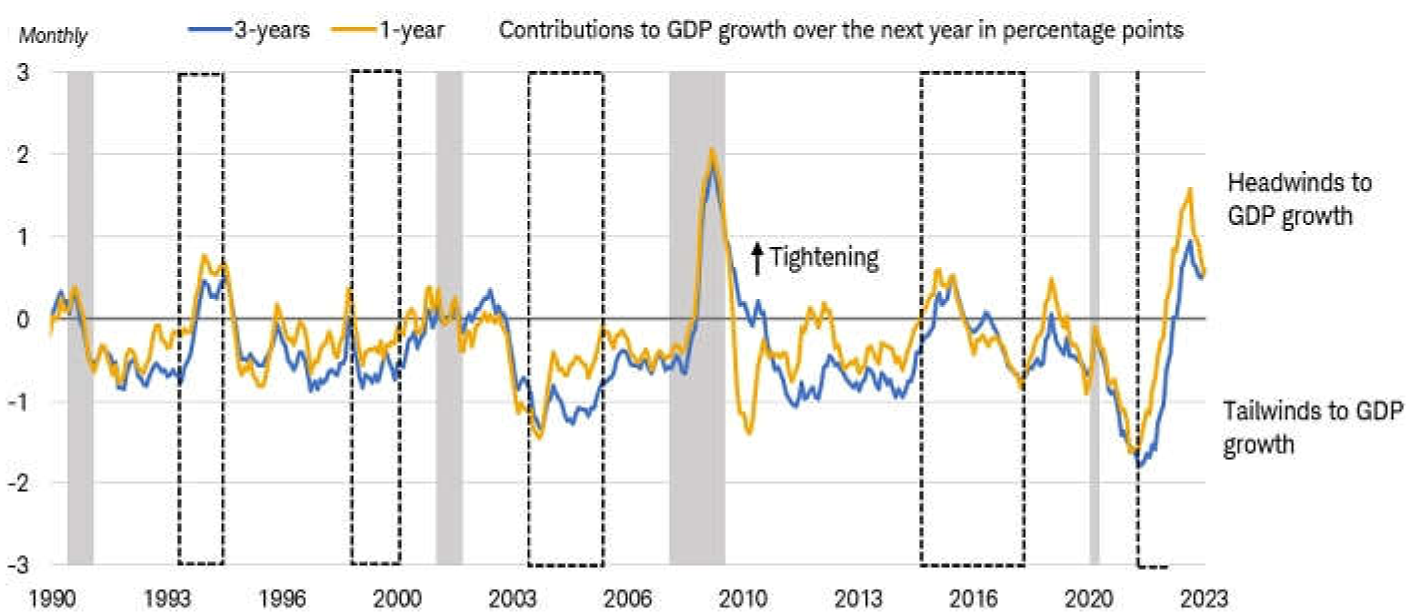


Source: Bloomberg.

Federal Reserve's Senior Loan Officer Survey: Net Percent of Domestic Respondents Tightening Standards for Commercial & Industrial Loans for Large/Medium Sized Firms and Small Firms, and the NBER's U.S. Recession Index (SLDETIGT Index, SLDETIGTS Index, and USRINDEX Index). Shaded areas indicate past recessions. Monthly data as of 06/30/2023.

The Fed's own model suggests that financial conditions are tight. An index constructed by the New York Federal Reserve Bank shows that headwinds to economic growth from tighter policy are near the highest levels since 2008.

Financial conditions are the tightest in more than a decade



Source: Federal Reserve, data as of 6/30/2023.

Chart shows the Financial Conditions Impulse on Growth computed with a 1−year and 3−year lookback window, respectively, in blue and yellow. Positive (negative) values of the two indexes denote headwinds (tailwinds) to GDP growth over the next year. The upward arrow indicates the direction of tightening of financial conditions and increasing headwinds to future GDP growth. Gray shaded bars denote periods of recession as dated by the National Bureau of Economic Research: July 1990-March 1991, March 2001-November 2001, December 2007-June 2009, and February 2020-April 2020. The dashed bars represent monetary policy tightening cycles: February 1994-March 1995, July 1999-July 2000, June 2004-August 2006, December 2015-July 2018, March 2022-present. Tightening cycles are defined to start on the month of the first federal funds rate increase and end after the last rate hike.

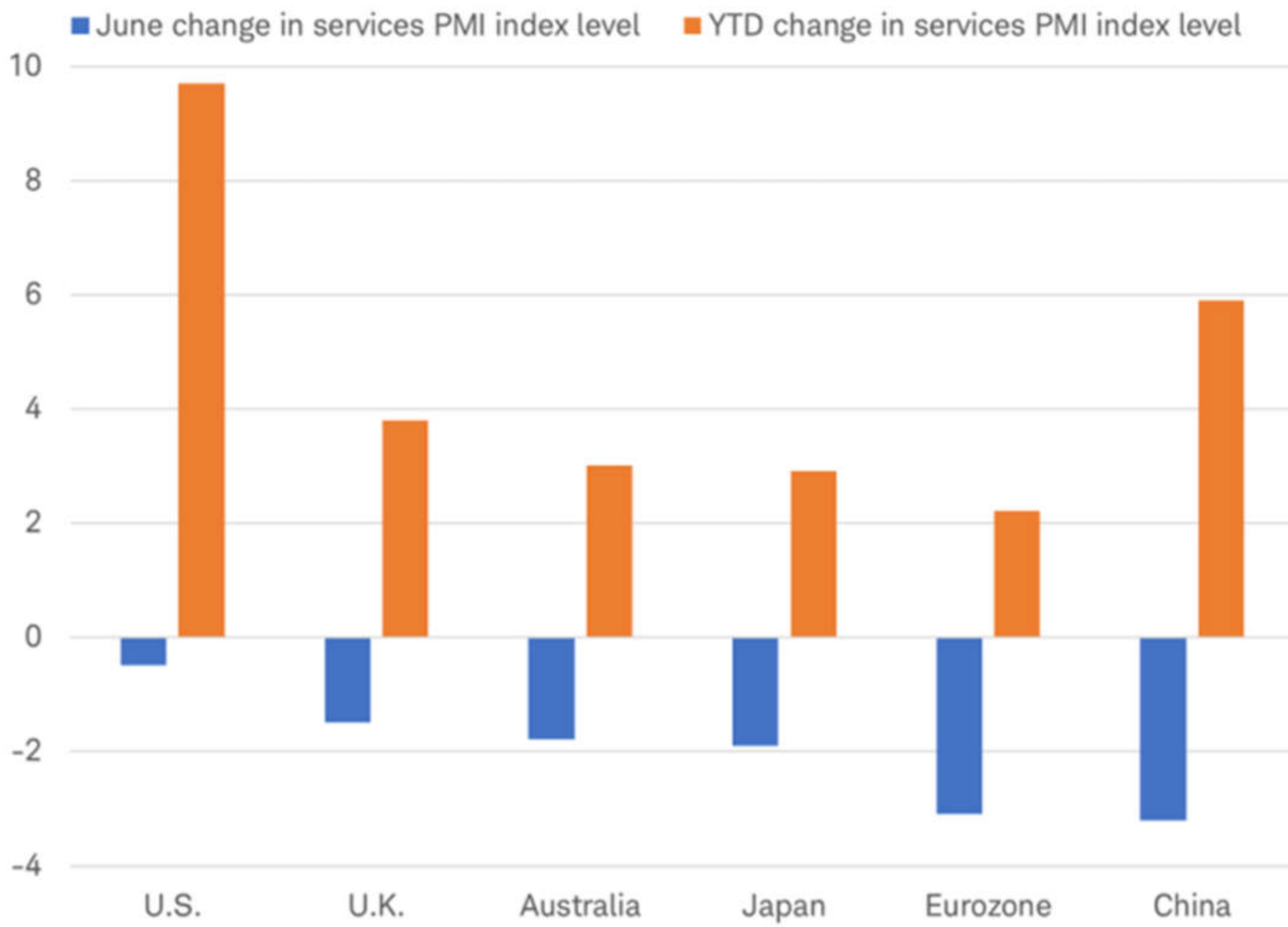
Although we lean toward the market view that Fed policy is restrictive enough to bring inflation down longer term, the Fed appears inclined to ignore lags between tightening policy and the impact on the economy. One to two more rate hikes will raise the "terminal rate" for the current rate-hike cycle. Given how steeply inverted the yield curve is already, it suggests that the lower end of the range for 10-year Treasury yields likely will be closer to 3.5% than the 3.0%-to-3.25% range we previously had anticipated. On the upside, we still see the highs from October in the 4.25% to 4.35% region holding.

Our concern is that by overdoing its rate hikes, the Fed might cause a recession or potentially trigger another round of problems in the banking sector. We suggest investors use rising yields to add duration to portfolios and focus on higher-credit-quality bonds.

Global stocks and economy: Signs of a sagging economy

A key risk we cited in our global mid-year outlook was the potential for the services sector of the global economy to begin to weaken and converge with the recession taking place in the manufacturing sector. As the first half of the year ended, signs emerged that this risk was increasing. The Purchasing Managers' Index (PMI) for services businesses fell across all major countries in June, after rising for much of the first half of the year.

Services PMIs fell across all major countries in June after rising for much of the first half



Source: Charles Schwab, S&P Global data as of 7/7/2023.

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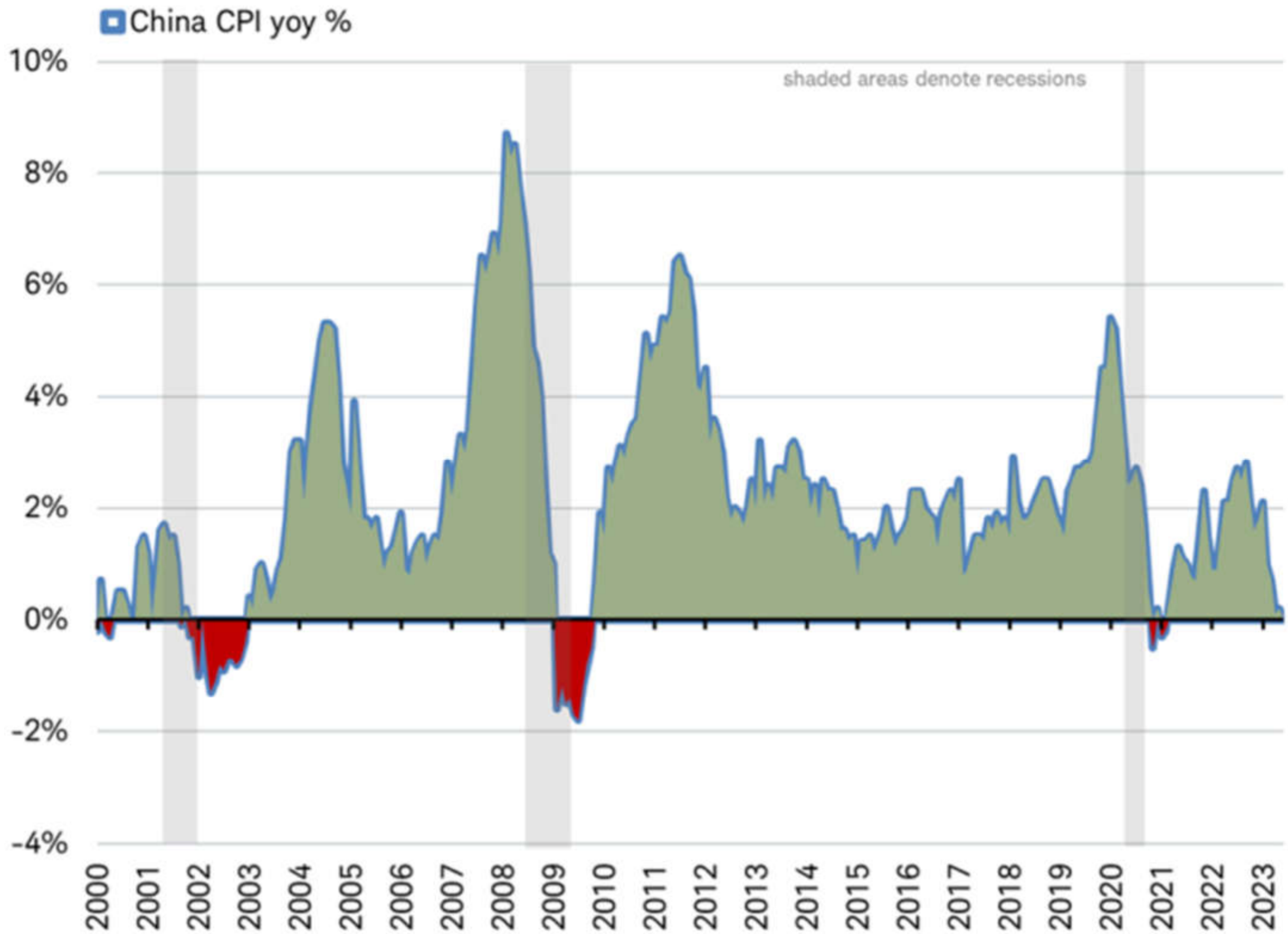
It's too soon to call a recession in the services sector, but if the services PMI continues to worsen, the current "Cardboard Box" recession, so named because it is concentrated in manufacturing and trade, could broaden into a full-fledged recession. Services are more labor-intensive and employ more people than manufacturing, which tends to be more capital-intensive. For example, in the U.S. private sector there are 135 million services jobs compared with 13 million manufacturing jobs, a ratio of about 9-to-1, as of June 2023, according to the U.S. Bureau of Labor Statistics. In the European Union, the ratio is lower, at about 4-to-1, but still overwhelmingly tilted toward services, per Eurostat data.

Meanwhile, signs for the manufacturing side of the economy worsened in June, with new orders falling at a faster pace than inventories and the number of economies with manufacturing PMIs not in recession falling to just 29%. These indicators suggest additional manufacturing weakness in coming months.

Another worrisome sign for the global economy is that China is on the cusp of deflation. China ended the first half of the year with inflation falling to 0.0%. The world's second-largest economy is closely tied to global demand. Historically, dips by inflation into negative territory have happened only during periods around global recessions (2001, 2008-09 and 2020).

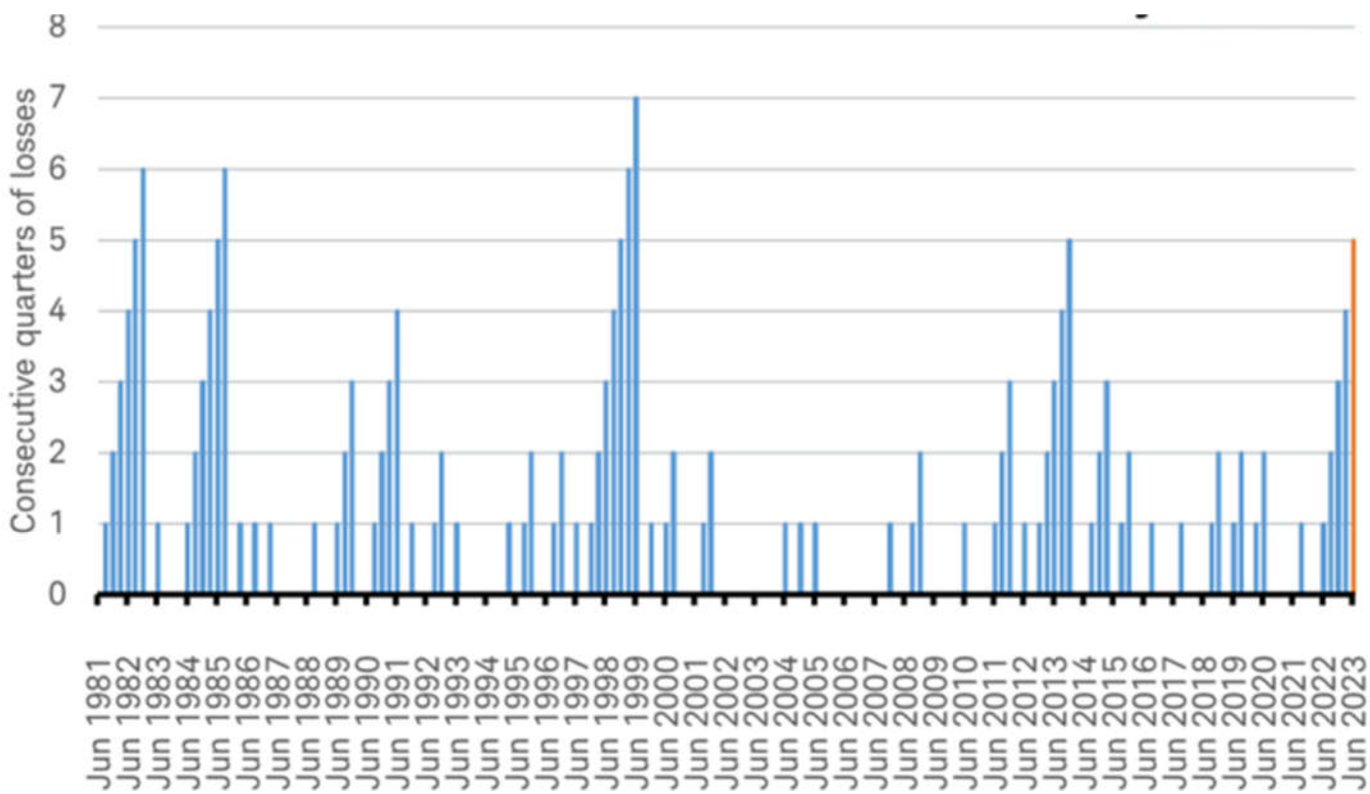
China: Deflation and recessions



Source: Charles Schwab, Bloomberg data as of 7/10/2023.

Finally, weak global economic activity has also contributed to five straight quarters of declines for commodities, as measured by the CRB All Commodity Price Index. That streak ties the record for declines seen so far this century. Not since the late 1990s have commodities seen a more extended slump.

Commodities haven't seen more than five quarters of losses since the 1990s



Source: Charles Schwab, Commodity Research Bureau (CRB), Bloomberg, as of 7/7/2023.

The CRB All Commodity Price Index is a measure of price movements of 22 basic commodities whose markets are presumed to be among the first to be influenced by changes in economic conditions.

A further slowdown in economic activity may risk a global recession but could convince central bankers that inflation is reliably on a path toward target levels, leading to an end to the rate-hiking cycle. For investors, a clear signal that the end of the rate-hiking cycle is near could help offset the downside risk to economic and earnings growth.

[1] A basis point is one-hundredth of 1 percentage point, or 0.01%, so 25 basis points would be equal to 0.25%.

Kevin Gordon, Senior Investment Strategist, contributed to this report.