Charles Schwab

4 Weak Spots in the Current Market

November 17, 2023

Today's uncertain economic climate is putting particular pressure on four market segments. Here's what to watch out for in the months ahead.

A one-two punch of persistent inflation and high interest rates is creating pockets of weakness across the investment universe.

We polled Schwab experts for their views on which segments of the market look most vulnerable—and what steps investors can take to minimize their exposure, and maybe even profit if the opportunity presents itself.

Commercial real estate

What's the matter: According to the Pew Research Center, more than a third of U.S. workers who can work from home now do so full time. As a result, between the end of 2019 and the beginning of 2023, the office vacancy rates in New York and San Francisco alone increased 14.2% and 19.8%, respectively. By 2030, more than 300 million square feet of U.S. office space is expected to be obsolete.

On the financing side, nearly $900 billion in U.S. commercial property debt is set to mature this year and next. Property owners will almost certainly face higher rates, and those who can't afford to refinance will be forced to inject millions of dollars in fresh capital, sell, or simply walk away. "This isn't something that gets solved over the next couple of years," says Kevin Gordon, senior investment strategist at Schwab.

What to do about it: Commercial real estate is a broad category, so to say the entire sector is struggling is an overstatement. "Much of the stress in the sector is around office space, and you can boil down the issues to a handful of big cities," Kevin says. "As an investor, you have to consider the fuller picture."

In fact, parts of the market are holding up nicely, thank you very much. Student housing is one such area. Rents are growing by about 9% because of limited supply and strong demand at many colleges. The data centers that are key to the cloud computing and artificial intelligence industries are another bright spot. In the seven main U.S. data center markets, leasing rose 40% between March 2022 and March 2023, while vacancies fell to a record low of 3.2%.

Despite these areas of strength, Kevin suggests sticking to higher-quality stock investments—such as those with low debt and strong cash flow—amid the uncertainty.

Research high-quality stocks

To research high-quality stocks, log in to **schwab.com/stockscreener** and under Financial Strength:

1. Select Debt to Equity, then <1.

2. Select Cash Flow Per Share, then 10–15, 15–20, and >20.

High-yield bonds

What's the matter: Although high-yield bonds have been one of the best-performing areas of fixed income,[1] that strong performance came despite a rise in corporate defaults—a trend that may continue as high borrowing costs weigh on low-rated issuers.

Corporate earnings have faltered in the wake of the Fed's aggressive interest-rate hikes. Companies in the S&P 500® Index posted year-over-year profit declines for two successive quarters starting in the fourth quarter of 2022—the technical definition of an earnings recession.[2] Moreover, corporate pretax profits declined in four consecutive quarters through the second quarter of 2023, according to the Bureau of Economic Analysis.

"Prolonged earnings weakness will hurt the ability of high-yield issuers to find investors willing to refinance their debt," says Collin Martin, CFA®, a director and fixed income strategist at the Schwab Center for Financial Research. "As it stands, those who issued high-yield debt two years ago are paying double in interest expense now—and it's only going to get tougher for companies to withstand the increase in their borrowing costs."

What to do about it: Collin says that older investors who count on investment income to fuel their spending should favor investment-grade corporate bonds rather than high-yield bonds in the immediate term, since investment-grade corporate bond yields are near the highest they've been in more than a decade.[3]
To research investment-grade corporate bonds, log in to **schwab.com/bondsource** and select Corporates under Bond Type. You can search based on credit rating, but keep in mind that most of the investment-grade corporates market is composed of bonds rated A and BBB.[4]

Those continuing to hold high-yield bonds should closely examine the specifics, including how the debt is rated, whether it's secured or unsecured, and whether the market is liquid enough to accommodate a sale. "Even in the high-yield space, you can have big differences in credit ratings," Collin says. "Ideally, you want to be a bit more defensive and focus on bonds or bond funds that favor higher-rated issues."

- To research high-yield bonds, log in to **schwab.com/bondsource** and select Sub-Inv Grade Corporates under Bond Type. To refine your search, limit it to Standard & Poor's BB-rated bonds[5] under the Ratings section, as they generally have lower default rates than those with lower ratings.

- To research high-yield bond funds, log in to **schwab.com/fundscreener** or **schwab.com/ETFscreener** and select Fund Category under Basic, then Taxable Bond, then High-Yield Bond.

Small-cap stocks

What's the matter: Unit labor costs—or how much a business pays its workers to produce one unit of output—increased at a rate of 6.3% in the first quarter, compared with just 3.3% in the prior period. That's an acute issue for small businesses, for whom labor costs constitute some 70% of their spending.

In fact, small businesses repeatedly report that labor shortages are hampering their operations, with many struggling to offer adequate compensation. While the growing economy *theoretically* enables them to boost sales, there's a limit to how much they can sell given their capacity constraints.

"The higher core costs that small businesses are incurring aren't likely to go down as fast as the inflation that's boosting their sales—and any downturn would likely see small companies' revenues come under pressure even as their cost of goods sold remains elevated," says Adam Lynch, a senior quantitative analyst at Schwab Equity Ratings.

Such headwinds are already apparent in the performance of small-cap indexes like the Russell 2000®, which gained about 12% through the first half of 2023, compared with an 18% rise in the broader S&P 500.

What to do about it: Look for high-quality large-cap companies with strong balance sheets and pricing power. "Market leaders are in a position to control prices in a way smaller companies typically cannot," Adam says, "which is why we're favoring larger-cap stocks, at least for the foreseeable future."
To research high-quality large-cap companies, log in to **schwab.com/stockscreener** and:

1. Under Basic, select Market Capitalization, then Large Cap.
2. Under Financial Strength, select Debt to Equity, then <1.
3. Under Financial Strength, select Return on Equity, then >30%.

If you're committed to investing in small-cap stocks, look for businesses with strong cash flows and a history of successfully navigating at least one economic downturn. Investing in a small-cap stock fund can also help you navigate the sector's vulnerabilities—so long as you find a manager who is focused on valuation or strong financials. You could also consider a fundamental small-cap fund, which weights its stocks in relation to their underlying financial strength. "There are certainly going to be opportunities to shop for good values, but you'll need to be really selective," Adam says. To research fundamental small-cap funds, log in to **schwab.com/fundscreener** and under Currently Selected Criteria, select New Screen. Then, under Basic Criteria:

1. Select Fund Category, then U.S. Equity, then Small Blend, Small Growth, and Small Value.

2. Select Search By Name, then enter "fundamental."

Regional banks

What's the matter: The failure of Silicon Valley Bank in March promptly sent regional bank stocks reeling. Although the KBW Nasdaq Regional Banking Index has since recouped some of its losses based on signs that the crisis was contained, the sector's problems may not be over.

The core vulnerability stems from the impact of higher interest rates, which undercut the value of the banks' outstanding fixed-rate bonds and other loans issued when rates were near zero. And despite their best efforts to trim their U.S. commercial real estate and construction exposure, regional banks are still the biggest lenders to the commercial real estate and construction markets. Indeed, a study of nearly 5,000 banks' public regulatory data found that approximately a sixth have either a CRE or construction loan concentration in excess of 300% or 100%, respectively, of their total capital, exceeding regulatory thresholds.

"Commercial real estate and construction is a significant chunk of exposure for smaller banks, and that doesn't work in a world of sky-high vacancy rates and ever-increasing borrowing costs," Adam says. "They're in a tough spot."

What to do about it: While regional banks may be overly concentrated in commercial real estate and construction—while also struggling to hold on to their cash depositors in the face of historically high yields offered elsewhere—bigger banks are better diversified through businesses such as investment banking and wealth management. Bigger banks also tend to be better capitalized—and may soon face a 20% boost to their capital requirements as regulators seek to shore up the banking system.

"The big banks have extensive playbooks that smaller players simply don't have," Adam says. "Plus, many have strong balance sheets and access to investment banking revenues that make them particularly appealing now."
To research large bank stocks, log in to **schwab.com/stockscreener** and under Basic:

1. Select Market Capitalization, then select Large Cap.

2. Select Sectors and Industries, then Financials, then Banks, then Diversified Banks.

Avoiding value traps

In addition to the previously outlined potential pitfalls in the economy, Adam, Collin, and Kevin caution it's also important to avoid "value traps," or investments with depressed prices that seem too low to last. The trio agree that valuation is a terrible market-timing tool and is better viewed as a measure of investor sentiment, which can persist for some time.

"There are definitely segments of the market that look extremely cheap from a valuation perspective, but they're cheap because of their negative near-term outlook," Kevin says.

"The well runs dry at some point, and you don't want to be the first one rushing to add water."

[1]The Morningstar U.S. High Yield Bond Index gained 5.4% in the first half of 2023.

[2]Jess Menton and Alexandra Semenova, "Why the US Stock Market Is Looking Past the 'Earnings Recession,'" bloomberg.com, 07/19/2023.

[3]Bloomberg US Corporate Bond Index average yield-to-worst of 5.8%, as of 09/12/2023.

[4, 5]The Moody's investment-grade rating scale is Aaa, Aa, A, and Baa, and the sub-investment-grade scale is Ba, B, Caa, Ca, and C. Standard and Poor's investment-grade rating scale is AAA, AA, A, and BBB, and the sub-investment-grade scale is BB, B, CCC, CC, and C. Ratings from AA to CCC may be modified by the addition of a plus (+) or minus (–) sign to show relative standing within the major rating categories. Fitch's investment-grade rating scale is AAA, AA, A, and BBB, and the sub-investment-grade scale is BB, B, CCC, CC, and C.