MARKETS AND ECONOMY

Schwab Market Perspective: Something for Everyone

January 12, 2024 Liz Ann SondersKathy JonesJeffrey Kleintop

Economic data has provided encouragement for both stock market bulls and bears.

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Economic data continues to provide evidence to satisfy both optimists and pessimists. Even if stocks look relatively expensive and investor sentiment seems to have become more exuberant (which tends to be a contrarian signal) since the recent low in October, the good news is that market breadth is in a healthier position as 2024 begins.

As inflation continues to recede, we expect Treasury yields to continue to trend lower. The prospect of interest rate cuts by the Federal Reserve should be positive for the bond market, although we expect volatility to remain elevated. Meanwhile, a new European fiscal agreement may help some countries emerge from recession unimpeded by the harsh fiscal adjustments that would have been required under the old rules.

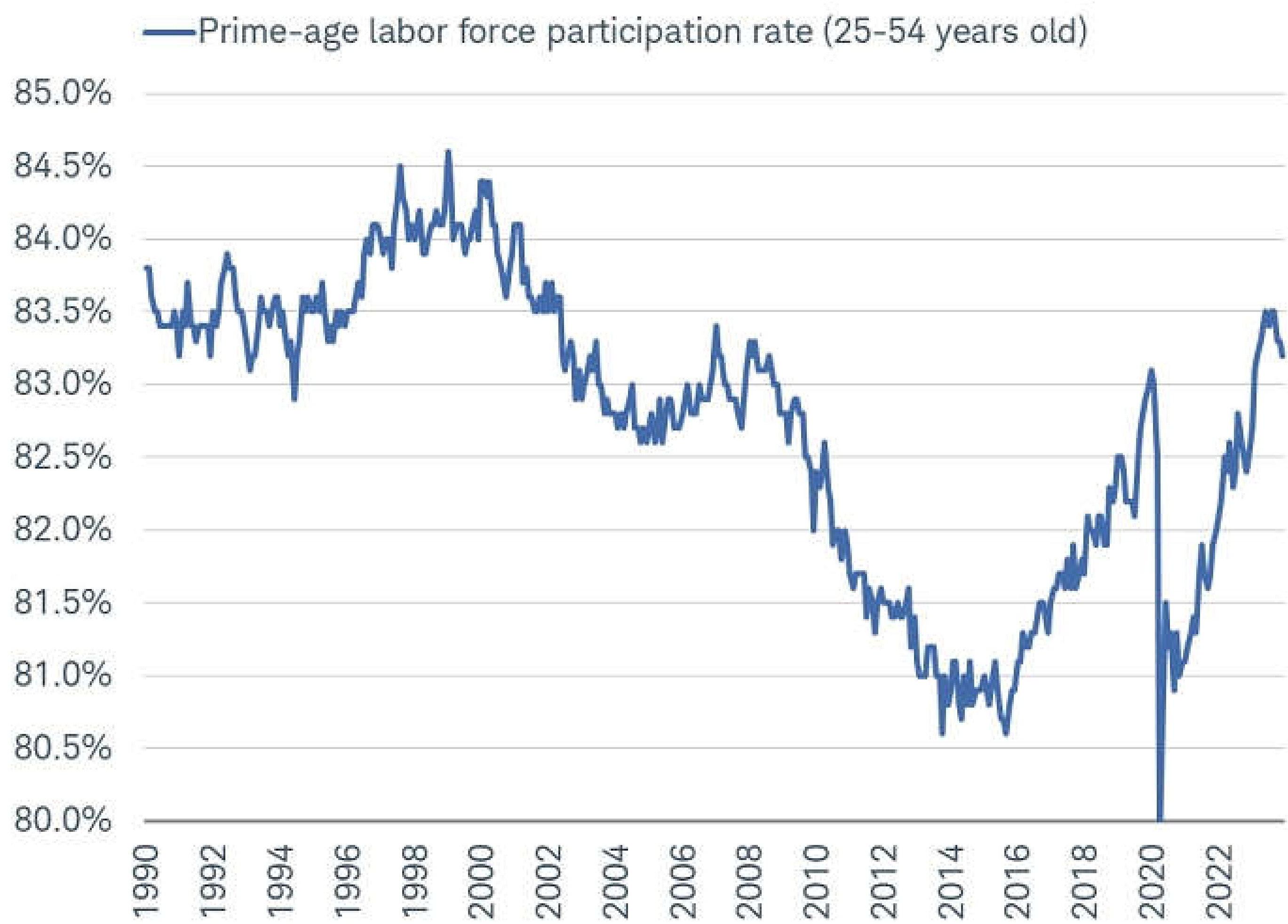
U.S. stocks and economy: This or that?

As has been the case for most of the post-pandemic period, economic data points have had enough to satisfy optimists' and pessimists' biases. Labor market data—in particular, the monthly jobs reports—have perhaps been the best examples of providing enough evidence for both the economic bulls and bears.

For instance, December's jobs report looked great on the surface—with 216,000 jobs created, an unchanged unemployment rate, and still-strong earnings growth. Yet, revisions resulted in 71,000 fewer payrolls in October and November; the unemployment rate was unchanged because of the decline in the labor force; and household employment fell by nearly 700,000 individuals.

To be sure, there are still several labor data that look relatively strong in level terms. As shown in the chart below, the prime-age labor force participation rate is at a healthy level relative to its plunge during the pandemic. However, rates of change matter more at potential economic inflection points. As such, investors should pay attention to the renewed downturn over the past few months. If it continues, it would signal increasing weakness in labor supply.

Labor force participation turning lower

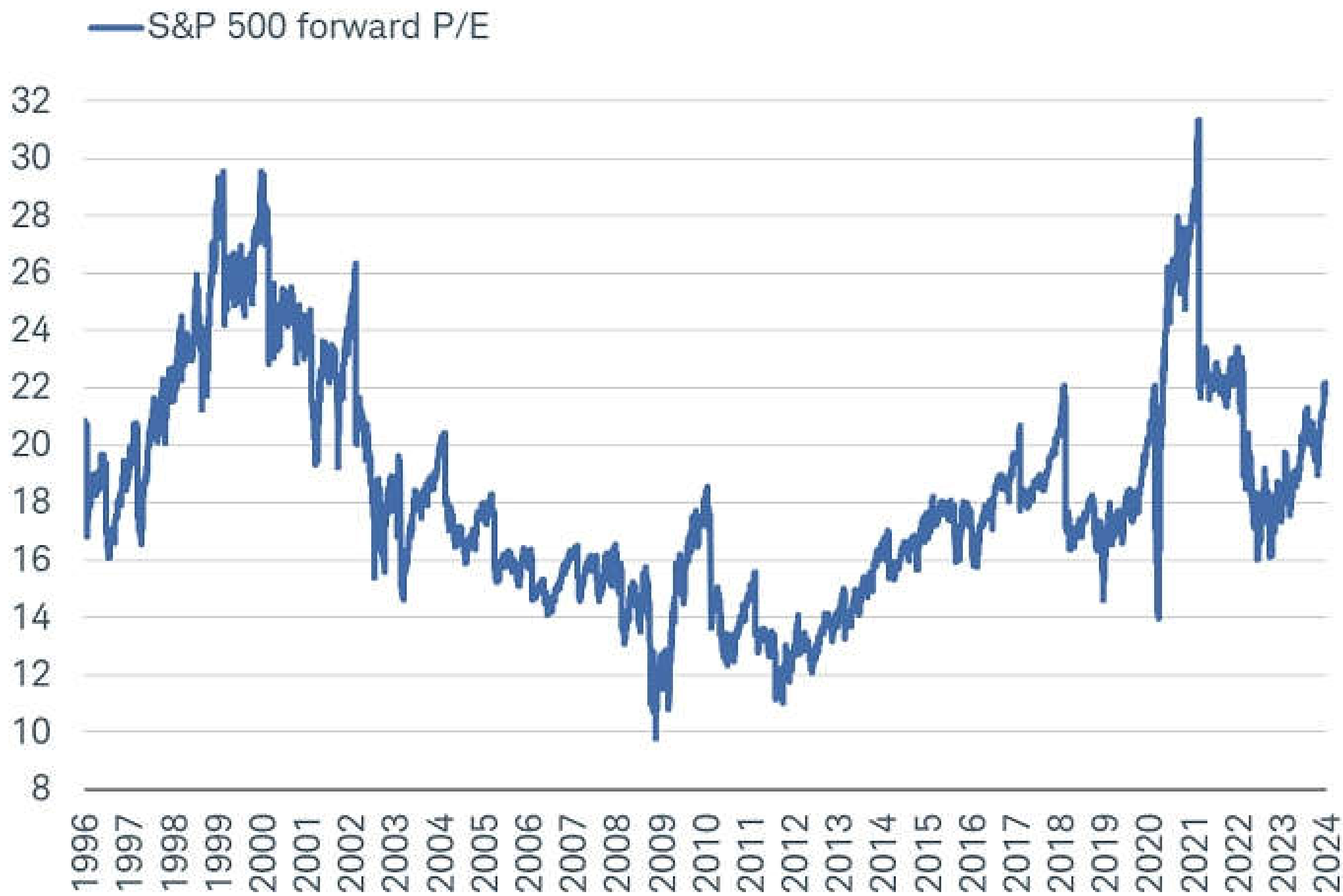


Source: Charles Schwab, Bloomberg, Bureau of Labor Statistics, as of 12/31/2023.

Any dent to labor supply would likely complicate the Federal Reserve's inflation fight, especially because wage growth is still running at a relatively brisk pace. That isn't to say a sudden resurgence in inflation is imminent, but it underscores the risk of a more volatile inflation environment moving forward.

All else being equal, more volatile inflation tends to coincide with stress for more richly valued parts of the stock market, and in turn means that price-to-earnings (P/E) multiples might face added pressure moving forward. As you can see in the chart below, the S&P 500's forward P/E has climbed substantially over the past year; save for some extreme periods in the late-1990s and early-2020s, the market looks quite expensive.

The S&P 500 index is relatively richly valued



Source: Charles Schwab, Bloomberg, as of 1/5/2024.

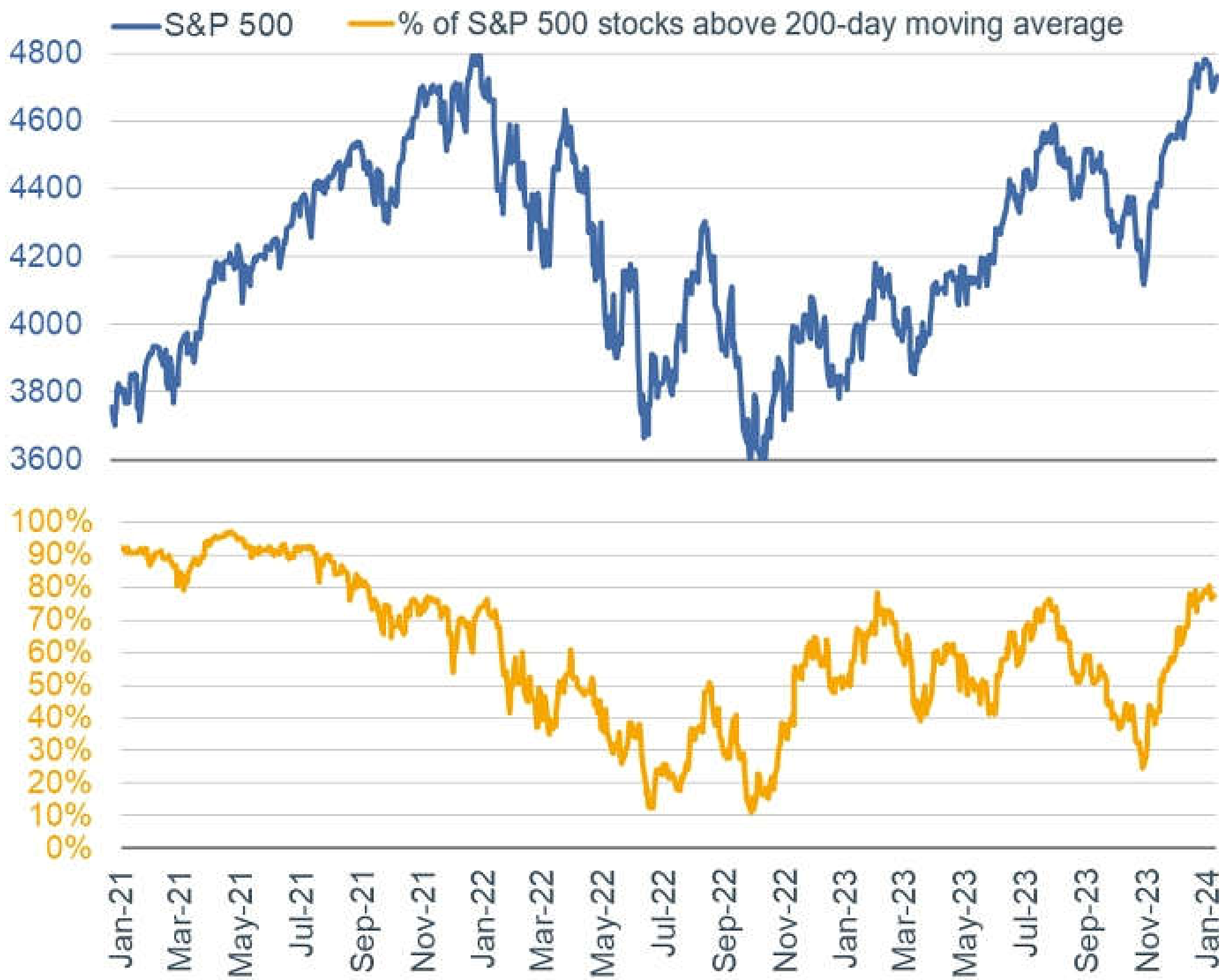
Past performance is no guarantee of future results.

While that does present some risk to the market in terms of how expensive it looks, we'd emphasize to investors that valuation is truly in the eye of the beholder. Not only can investors adjust the "E" they use in the P/E ratio (forward or trailing earnings growth); they can use other metrics to justify their market view—such as an equity risk premium or total market capitalization relative to gross domestic product (GDP).

Even if the market looks quite expensive and investor sentiment has seemingly gotten much frothier since the recent low in October, the good news is that market breadth is in a healthier position to start the year off. As shown in the chart below, the percentage of

S&P 500 members trading above their 200-day moving average recently reached the 80% threshold, which is typically an encouraging sign of a sustainable advance.

Breadth in a stronger position



Source: Charles Schwab, Bloomberg, as of 1/5/2024.

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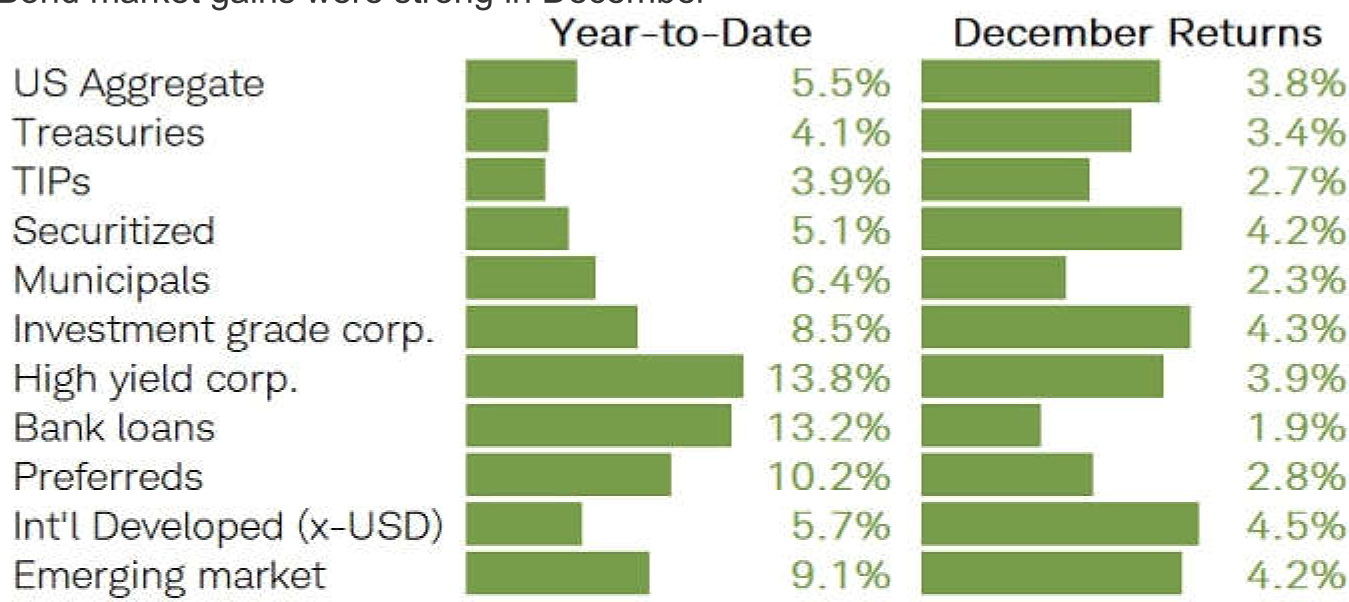
That isn't to say the upward trend will be devoid of selloffs. We continue to think volatility will stay elevated, especially as the market still looks to be ahead of the Fed in presuming rate cuts are approaching quickly.

Fixed income: What happened to "higher for longer"?

The bond market has started 2024 by giving back some of the gains seen in late 2023. That's not too surprising, as the gains in December alone were sizable and contributed to much of the positive total return for the year.

Bond market gains were strong in December



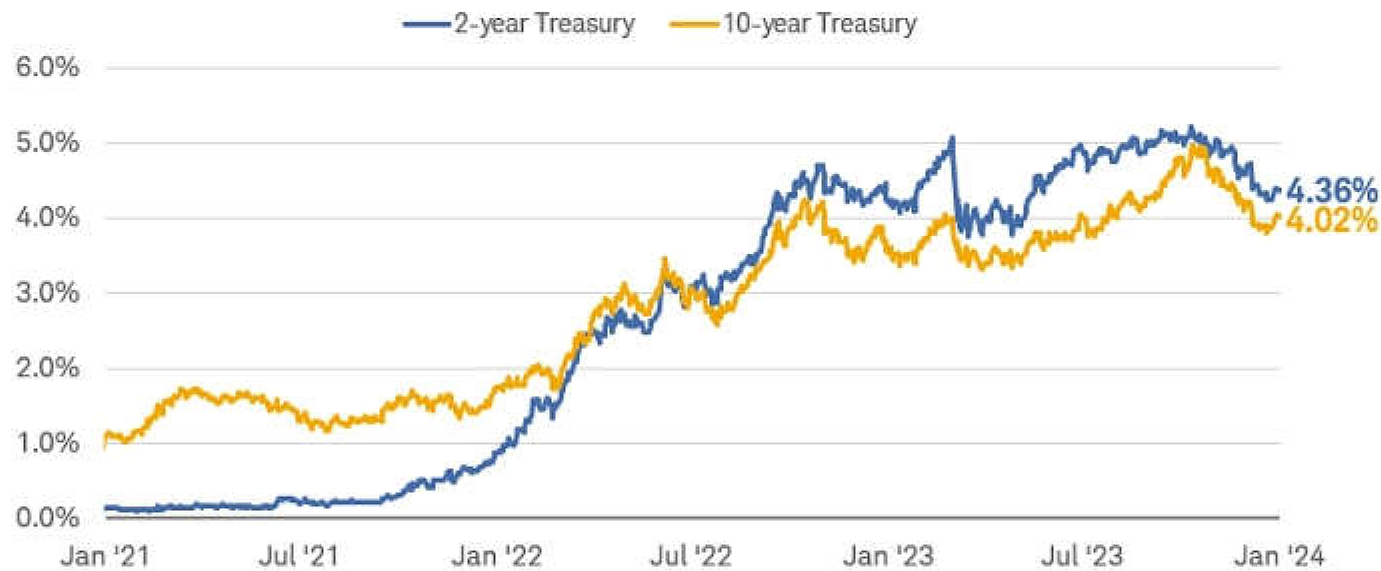
Source: Bloomberg. Total returns from 12/30/2022 through 12/29/2023 representing Year-to-Date and 11/30/2023 through 12/29/2023 representing December Returns.

Total returns assume reinvestment of interest and capital gains. Indexes are unmanaged, do not incur fees or expenses, and cannot be invested in directly. Indexes representing the investment types are: US Aggregate = Bloomberg U.S. Aggregate Index; Treasuries = Bloomberg U.S. Treasury Index; TIPS = Bloomberg US Treasury Inflation-Protected Securities (TIPS) Index; Securitized = Bloomberg US Securitized Index; Municipals = Bloomberg US Municipal Bond Index; Investment grade corp. =

Bloomberg U.S. Corporate Bond Index; High yield Corp = Bloomberg US High Yield Very Liquid (VLI) Index; Bank Loans = Morningstar LSTA US Leveraged Loan 100 Index; Preferreds = ICE BofA Fixed Rate Preferred Securities Index; Int. Developed (x-USD) = Bloomberg Global Aggregate ex-USD Bond Index; Emerging Market = Bloomberg Emerging Markets USD Aggregate Bond Index. **Past performance is no guarantee of future results.**

Although some retracement in yields seems reasonable, we expect the overall trend in yields to continue lower. Declining inflation and the prospect of interest rate cuts by the Federal Reserve should be positive for the bond market, although we expect volatility to remain elevated.

Treasury yields trended lower in the final months of 2023

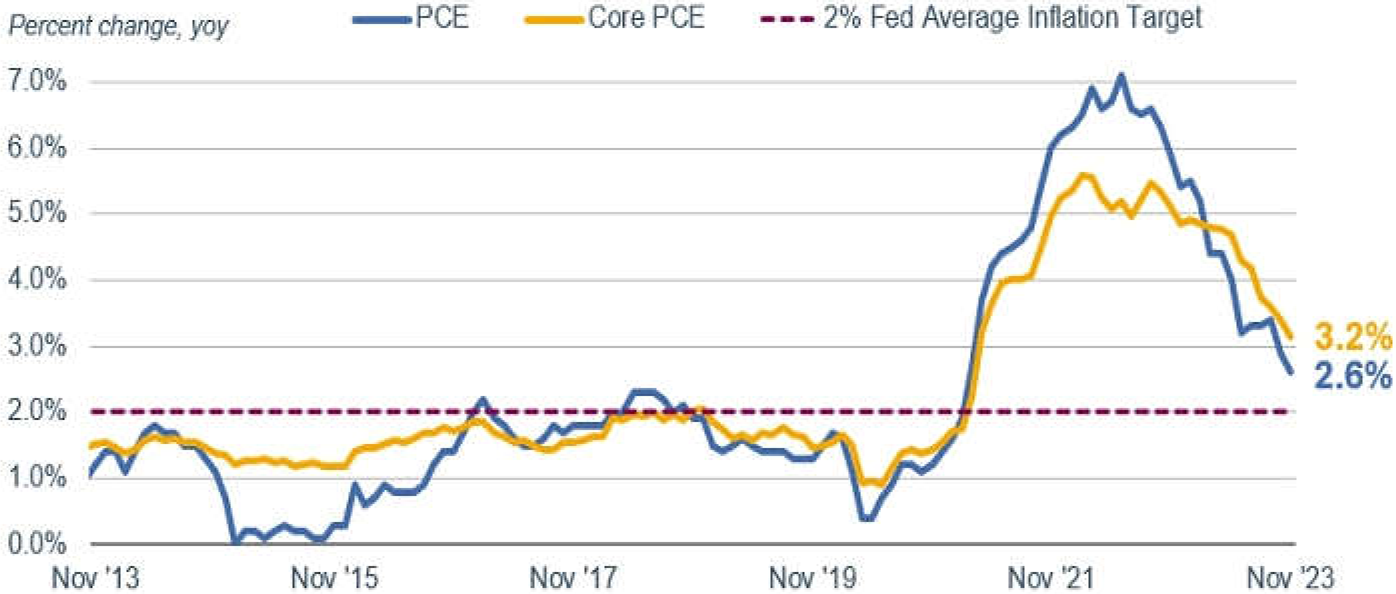


Source: Bloomberg. U.S. Generic 2-year Treasury Yield (USGG2YR INDEX) and U.S. Generic 10-year Treasury Yield (USGG10YR INDEX). Daily data as of 1/8/2024.

Past performance is no guarantee of future results.

The key factor driving the trend in interest rates has been falling inflation. The measure that the Federal Reserve uses for its benchmark of inflation—the core personal consumption expenditures index (core PCE), which excludes volatile food and energy prices, fell to a 3.2% year-to-year pace in December. It has been in a steady downtrend since reaching a 5.6% peak in February 2022. Moreover, the latest month-to-month readings have been tame, averaging just 0.2% over the past six months. If the trend were to continue, then the Fed's 2% inflation target could be reached by the fall.

Inflation has declined



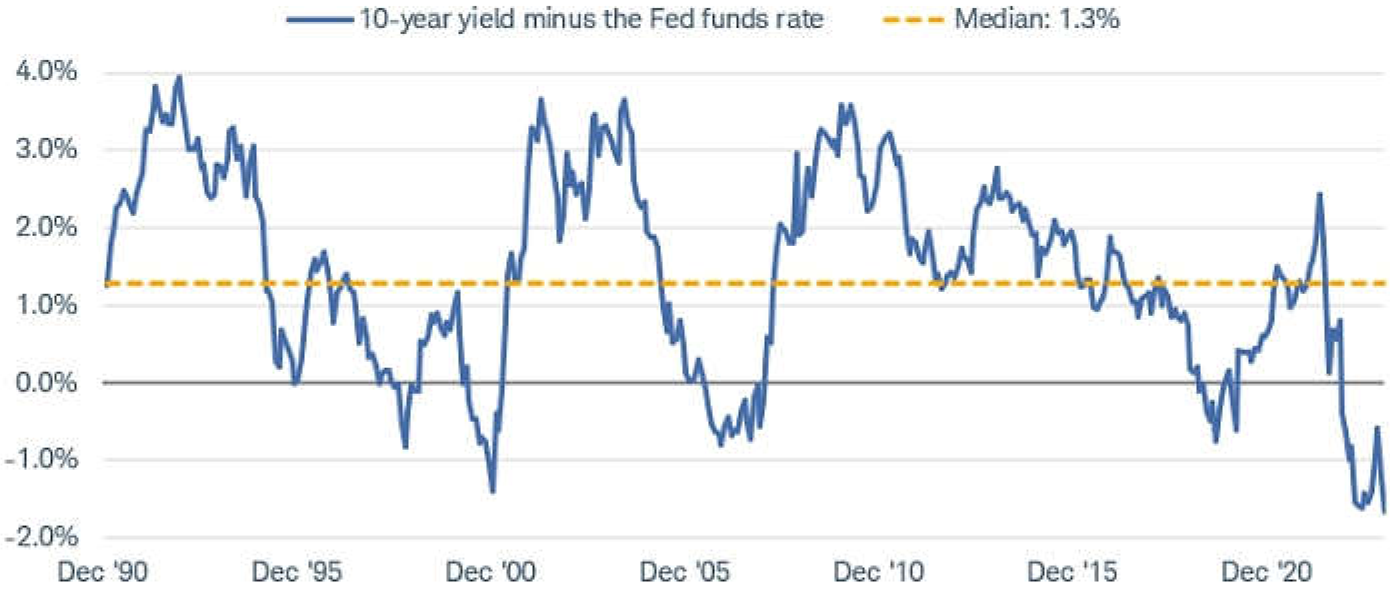
Source: Bloomberg.

PCE: Personal Consumption Expenditures Price Index (PCE DEFY Index), Core PCE: Personal Consumption Expenditures: All Items Less Food & Energy (PCE CYOY Index), percent change, year over year. Monthly data as of 11/30/2023.

We expect the Fed to begin cutting interest rates in mid-year, probably at the May meeting of the Federal Open Market Committee (FOMC). The markets are currently pricing in a 50% probability of a rate cut at the March meeting, but we believe that is likely too early. The Fed needs to see a consistent downtrend in the inflation rate toward its target to be comfortable starting an easing cycle, especially since the economy has been resilient.

While the prospect of rate cuts is positive for the bond market, intermediate to long-term yields are already pricing in close to a full cycle of easing. With the yield curve steeply inverted, the market is already reflecting a series of rate cuts. Historically, the spread between the Fed's policy rate—the federal funds rate—and 10-year Treasury yields has ranged widely from about -2.0% to nearly +4.0% with a median value of 1.3%. It is currently near the lower end of its broad range, signaling that there may not be much room for intermediate-term yields to fall until the Fed is well into its easing cycle.

The spread between the 10-year Treasury yield and the federal funds rate is low



Source: Bloomberg, using monthly data as of 12/29/2023. US Generic Govt 10 Yr (USGG10YR Index) and Federal Funds Target Rate – Upper Bound (FDTR Index).

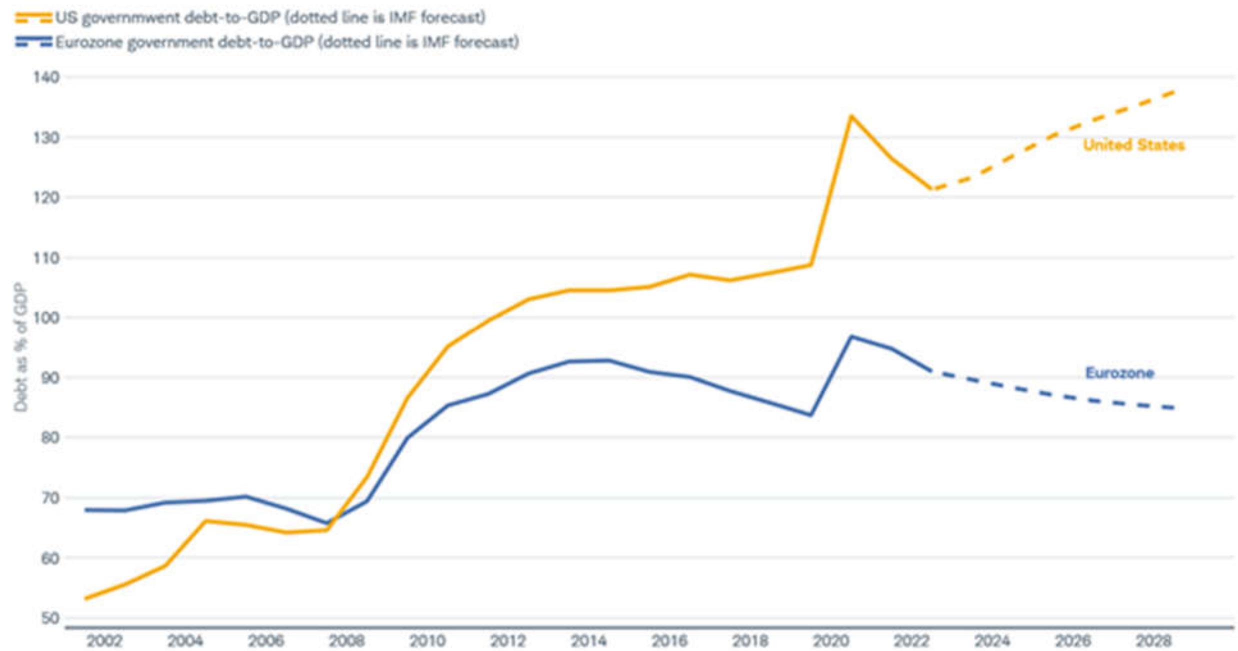
Nonetheless, current yields on "core" bonds—Treasuries, investment-grade corporate and muni bonds—look attractive on a risk/reward basis in our view. Volatility is likely to be elevated due to uncertainty about the timing and magnitude of Fed rate cuts, but with yields currently in the 4% to 5% region for most higher-rated bonds, the prospect for returns looks positive in 2024.

Global stocks and economy: Debt deal

While a battle in Congress over the United States' debt and deficit is set to heat up in early 2024, European Union (EU) member countries came to an agreement on their debt and deficit rules at the end of 2023. Several major changes have been made, generally shifts away from rigid numerical targets that included requiring countries with a deficit greater than 3% of GDP to cut it to less than 3% the following year and toward a longer-term and more flexible goal of debt sustainability while supporting EU policy priorities in defense, digitization, and energy transition.

The new framework is intended to avoid damaging growth and to preserve Europe's successful record of capping debt as a share of GDP. History suggests the EU's fiscal rules have been a success over the past decade. This is a sharp contrast with the U.S., where the debt-to-GDP ratio has tended to increase even during periods of solid economic growth. With U.S. debt-to-GDP set to continue rising over the next five years and eurozone debt expected to fall, according to data tracked by the International Monetary Fund, it is becoming increasingly apparent that the debt outlook of the world's largest developed economies has structurally diverged. We attribute this divergence partly to the EU's fiscal framework.

Structural divergence: Government indebtedness in the eurozone and U.S.



Source: Charles Schwab, International Monetary Fund, Macrobond as of 1/8/2024.

Forecasts contained herein are for illustrative purposes only, may be based upon proprietary research and are developed through analysis of historical public data.

There are several takeaways for 2024 related to the new fiscal agreement for Europe:

- **Lower eurozone break-up risks.** Any bargaining between eurozone member countries and the European Commission over fiscal adjustment paths may be more constructive. The new rules allow for a more flexible back-and-forth as well as include more realistic targets, likely making for smoother fiscal-adjustment negotiations.

- **The political center holds.** Polling suggests the European parliamentary elections in June 2024 may see the combined weight of the far-right parties in the European rise very modestly, leaving a centrist majority. This may result in more consistent industrial and trade policy.

- **The eurozone economy may improve in 2024.** Some members seem to be positioned to emerge from recession unimpeded by the harsh fiscal adjustments that would have been required under the old rules.

- **Rate cuts may begin.** The first rate cut by the European Central Bank is likely to take place in the first half of 2024 with the benefit of a clearer fiscal outlook.

- **More military support expected for Ukraine.** Despite opposition from Hungary in late 2023, it is expected that the EU will likely continue to scale up financial and military support for Ukraine in 2024, at the urging of German Chancellor Olaf Scholz.

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