Charles Schwab

MARKETS AND ECONOMY

Schwab Market Perspective: After the Landing

October 11, 2024

Liz Ann Sonders

Kathy Jones

Jeffrey Kleintop

Kevin Gordon

Has the Federal Reserve achieved an economic "soft landing"? A resilient U.S. economy suggests it may have.

Listen to the latest ***audio Schwab Market Perspective.***

The resilience of the U.S. economy suggests that the Federal Reserve—which began cutting interest rates in September—doesn't need to move quickly to head off a potential recession. While the Fed is still expected to continue cutting rates, it may do so at a slower pace.

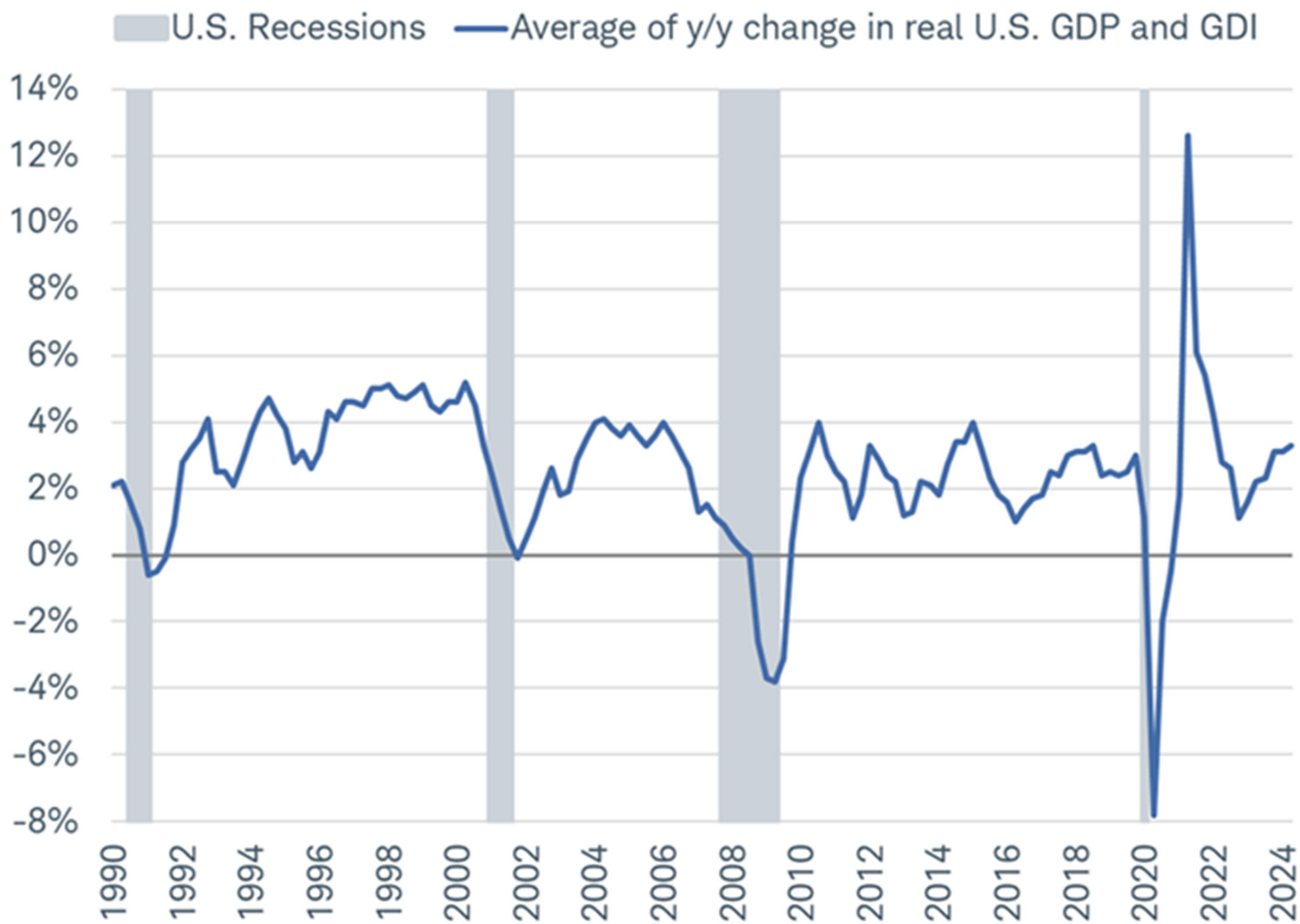
The notion that the Fed has successfully steered the economy to a "soft landing" (a slowdown without a recession) has led to a broadening stock market rally, with gains seen in a wider range of stocks. Ten-year Treasury yields also have risen as investors look to continued economic gains.

Up next: the U.S. election in November. But investors may want to take note that international elections in more than 80 countries so far this year haven't had much impact on the markets, and the U.S. election may be no different.

U.S. stocks and economy: A landing, then what?

Up until recently, among many irregularities in this unique cycle had been the glaring gap between growth in U.S. gross domestic product (GDP) and gross domestic income (GDI). For several years in the post-pandemic era, the former had been much stronger than the latter. That changed dramatically last month when the Bureau of Economic Analysis (BEA) released its annual benchmark GDP revision, which essentially closed the gap between GDP and GDI. In "real," or inflation-adjusted, terms, both expanded to 3.3% year-over-year in the second quarter of 2024. That is near the upper end of the range in the pre-pandemic economic expansion, and nowhere near recession territory.

Production and income strong

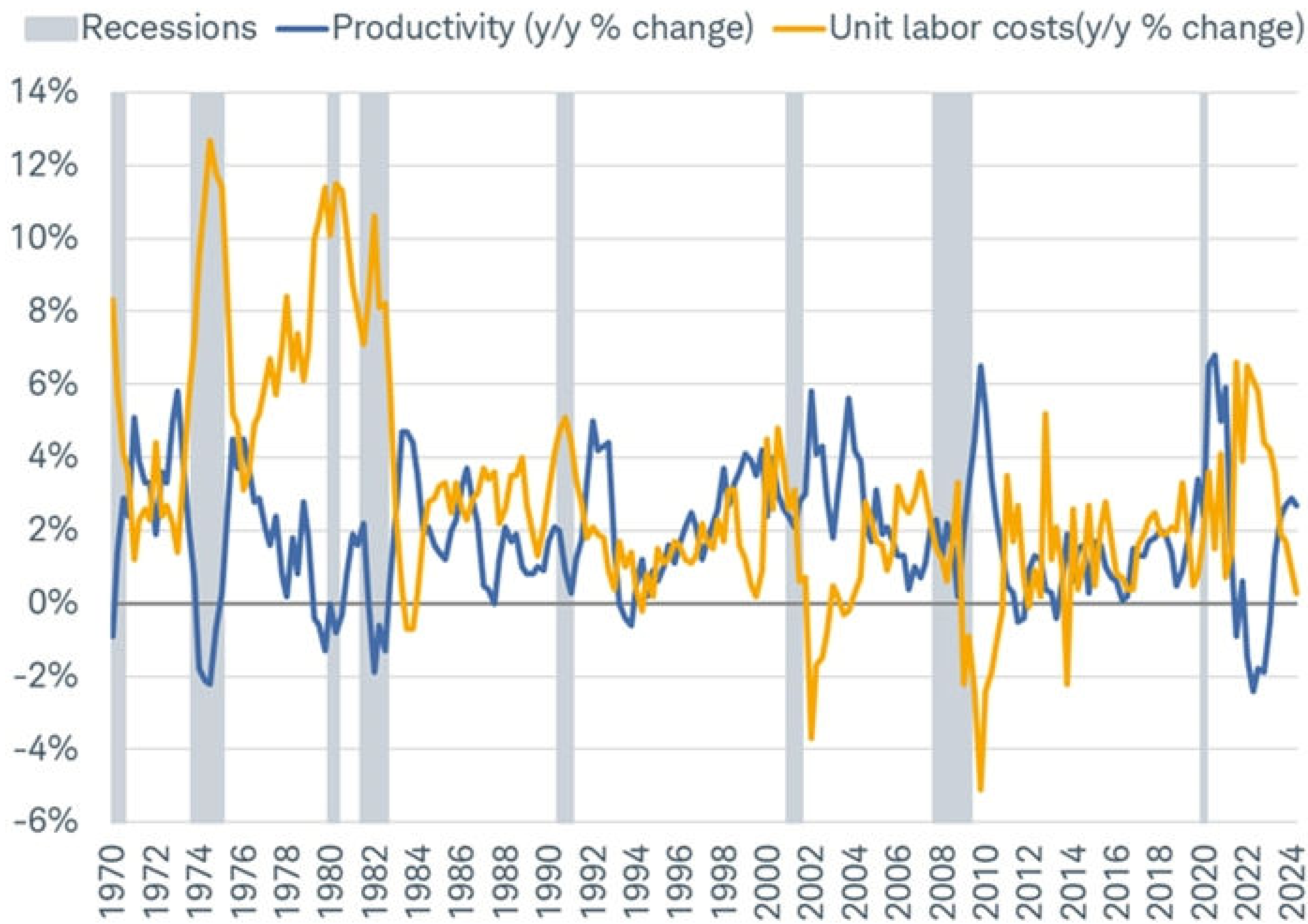


Source: Charles Schwab, Bloomberg, Bureau of Economic Analysis (BEA), as of 2Q 2024.

That helps support the notion that the economy has been experiencing a form of a soft landing over the past several years. Of course, as we have pointed out in the past, there have been pockets of weakness, most notably in manufacturing, housing, and consumer goods. Yet, with offsetting strength in services and labor, the broader economy has held together.

As growth and income metrics over the past several years have been revised higher, payroll growth has been revised lower. That combination means productivity growth has likely been much stronger than initially reported, which means unit labor cost growth has continued to cool down considerably. The downtrend in the latter has been a significant driver of disinflation; if we continue to see cost growth slow, it will help keep the lid on inflationary pressures.

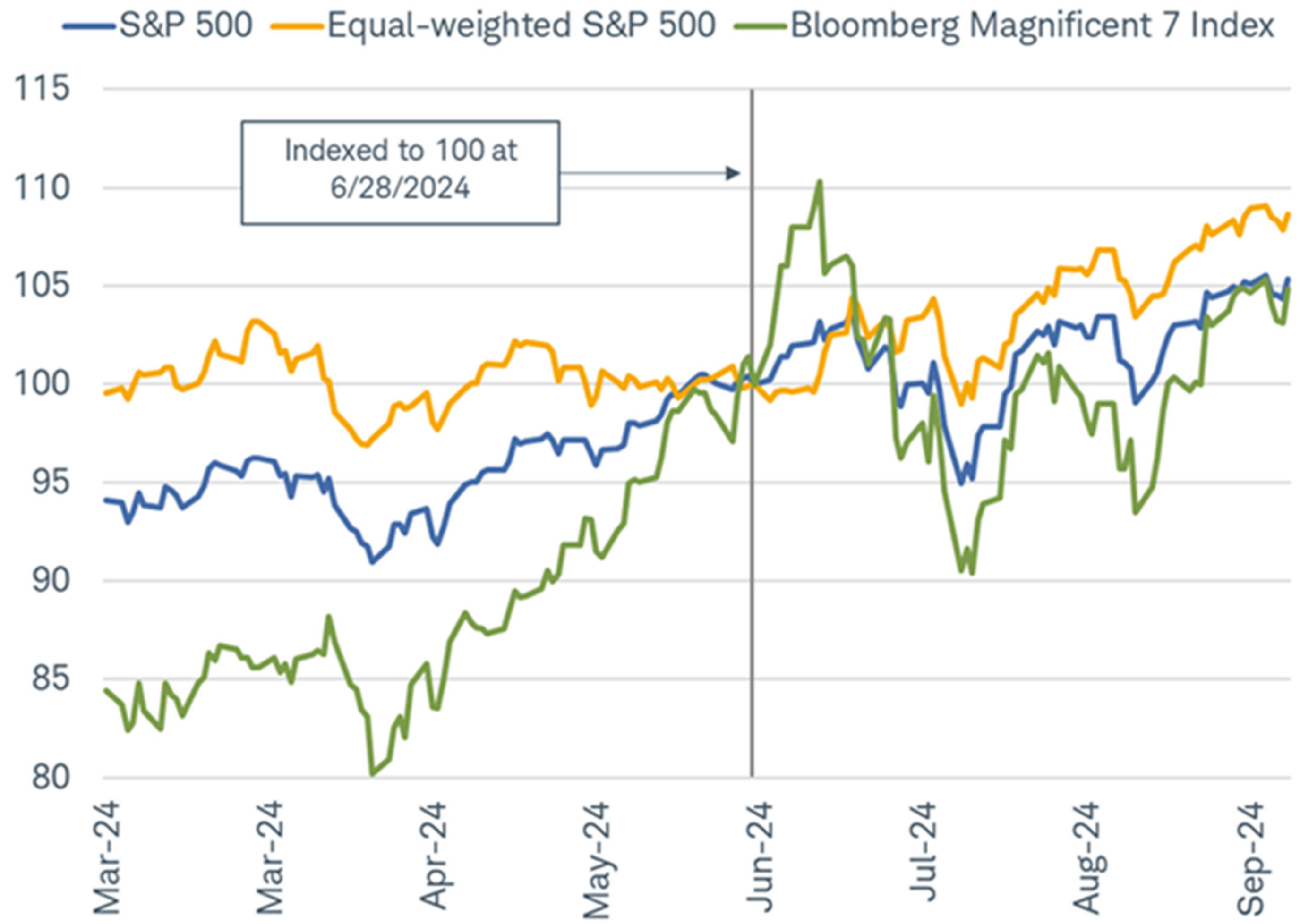
Labor-driven inflation easing



Source: Charles Schwab, Bloomberg, Bureau of Labor Statistics (BLS), as of 2Q 2024.

With growth holding up, inflation still trending lower, and Federal Reserve interest rate cuts soon (hopefully) alleviating pressure for the more economically sensitive parts of the economy, it's understandable that the stock market's rally has broadened. So far in the second half of the year, the equal-weighted S&P 500 has outperformed both the market-capitalization-weighted S&P and Magnificent 7 group of stocks (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla). That is a marked shift from the first half of the year, during which the mega-cap stocks dominated and constituted a good chunk of the overall market's gains.

A comeback for the "average stock"



Source: Charles Schwab, Bloomberg, as of 10/4/2024.

An index number is a figure reflecting price or quantity compared with a base value. The base value always has an index number of 100. The index number is then expressed as 100 times the ratio to the base value.. The S&P 500 index is a market-capitalization-weighted index that measures the performance of 500 leading publicly traded U.S. companies from a broad range of industries. The S&P 500 Equal Weight Index includes the same constituents as the capitalization-weighted S&P 500, but each company in the S&P 500 EWI is allocated a fixed weight, or 0.2%, of the index total. The Bloomberg Magnificent 7 Index is an equal-dollar weighted equity benchmark consisting of a fixed basket of 7 companies classified in the United States and representing the Communications, Consumer Discretionary and Technology sectors as defined by the Bloomberg Industry Classification System; currently, the companies are Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla. **Past performance is no guarantee of future results.**

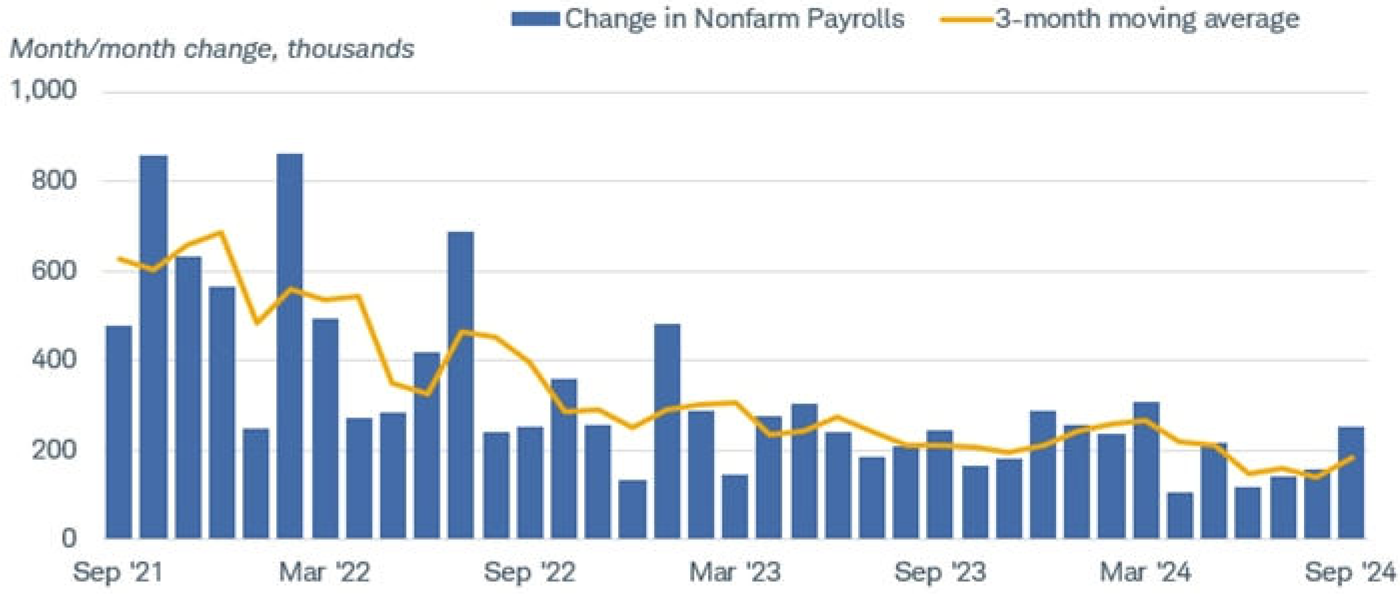
We think the rally can continue to broaden as the economy continues to grow, albeit at a slower pace. With sectors that were left behind in the early stages of this bull market now starting to catch up, index-level gains might look tamer and less exciting. As long as the majority of industries and members remain in uptrends, we think that will be a constructive backdrop—but not one without pockets of volatility.

Fixed income: Economy defies gravity, sending bond yields higher—for now

The U.S. economy continues to defy expectations by growing faster than expected. Despite all of the constraints placed in its way—tightening Federal Reserve monetary policy, weak global growth, wars in the Middle East and Ukraine, and low consumer confidence—GDP growth has been running at about a 3% annualized pace over the past four quarters. The major driver behind the growth is consumer spending. Supported by steady job and income growth, consumers are spending at a pace that is keeping the economy buoyant.

In the Treasury bond market, yields (which generally move inversely to prices) have rebounded on these signs of strength. The October unemployment report was much stronger than expected, with job growth of 254,000 and upward revisions to the estimates for the previous two months.

Job growth has been steady in recent months

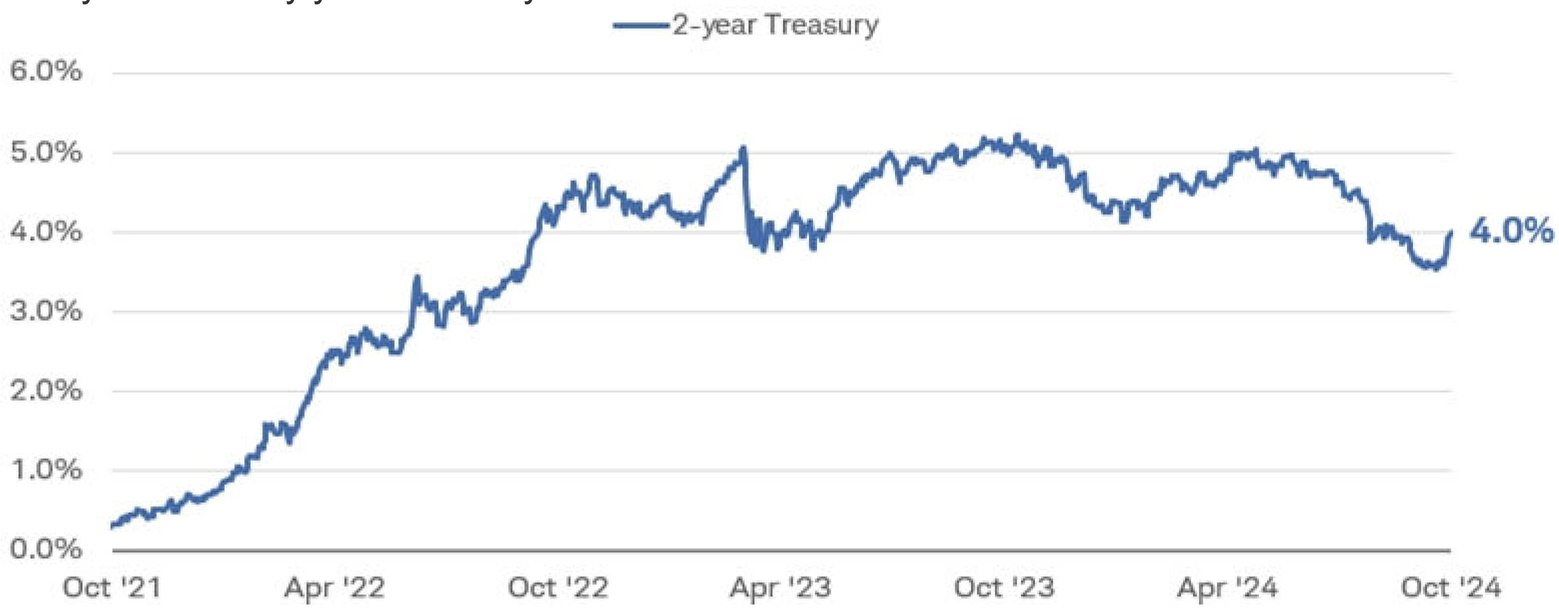


Source: Bloomberg, using monthly data as of 9/30/2022.

US Employment Total in Labor Force Net Change SA (USEMNCHG Index) and US Employees on Nonfarm Payrolls Total MoM Net Change SA (NFP TCH Index).

Two-year Treasury yields rose back to 4% for the first time since August as market expectations for the path of Fed rate cuts shifted. The resilience of the economy suggests that the Fed can move at a slower pace to ease policy. We do expect more rate cuts ahead—but fewer than previously estimated. The ending rate for the cycle is likely to be in the 3.0% to 3.25% range compared to the latest Fed estimate of 2.8%.

Two-year Treasury yields recently rose to 4%



Source: Bloomberg. Daily data as of 10/7/2022.

U.S. Generic 2-year Treasury Yield (USGG2YR INDEX) and U.S. Generic 10-year Treasury Yield (USGG10YR INDEX). **Past performance is no guarantee of future results.**

There is still room for rate cuts as long as inflation continues to trend lower, as we expect. It would be very unusual for the Fed to cut rates just once in a cycle. Moreover, not all growth is inflationary. In this cycle, productivity growth has been strong, indicating that there is room for more expansion without running into limits on inputs such as goods and labor. Real yields may be higher in this cycle compared to those seen in the post-global financial crisis (2007-2008) and COVID-19 shutdown (2020) eras, but not due to inflation. Rather, higher real rates are appropriate for a stronger economy.

The Fed sees itself in "risk management" mode. That is, policy is geared toward maintaining a healthy economy—preventing a sharp rise in unemployment while keeping inflation low. With inflation down sharply from its peak and economic growth near 3%, the current environment is positive. The Fed's goal is to maintain it, so major moves are less likely in the future. It will all depend on the balance of job growth versus inflation.

For investors, we look at the recent rebound in yields as an opportunity for those still holding high levels of short-term investments to extend duration. But we don't advocate overweighting duration beyond the individual investors' benchmark. We also suggest looking beyond the Treasury market to add intermediate-term bonds. Investment-grade corporate and municipal bonds offer attractive yields relative to the risk, in our view.

Global stocks and economy: Elections

With the U.S. election looming, this year has already set a record as the biggest election year in history, with voters in over 80 nations and territories representing more than half the world's population heading to the polls. Yet despite all the media coverage, investors may want to take note that the elections haven't had much impact on the markets this year.

In the latest general election, Austria's far-right Freedom Party won its first-ever general election victory on September 29. However, the Freedom Party appears unable to form a government after leaders of the other parties said they would refuse to join a coalition. In a repeating pattern of the global 2024 elections, this may hamper any policy proposals turning into actual policies.

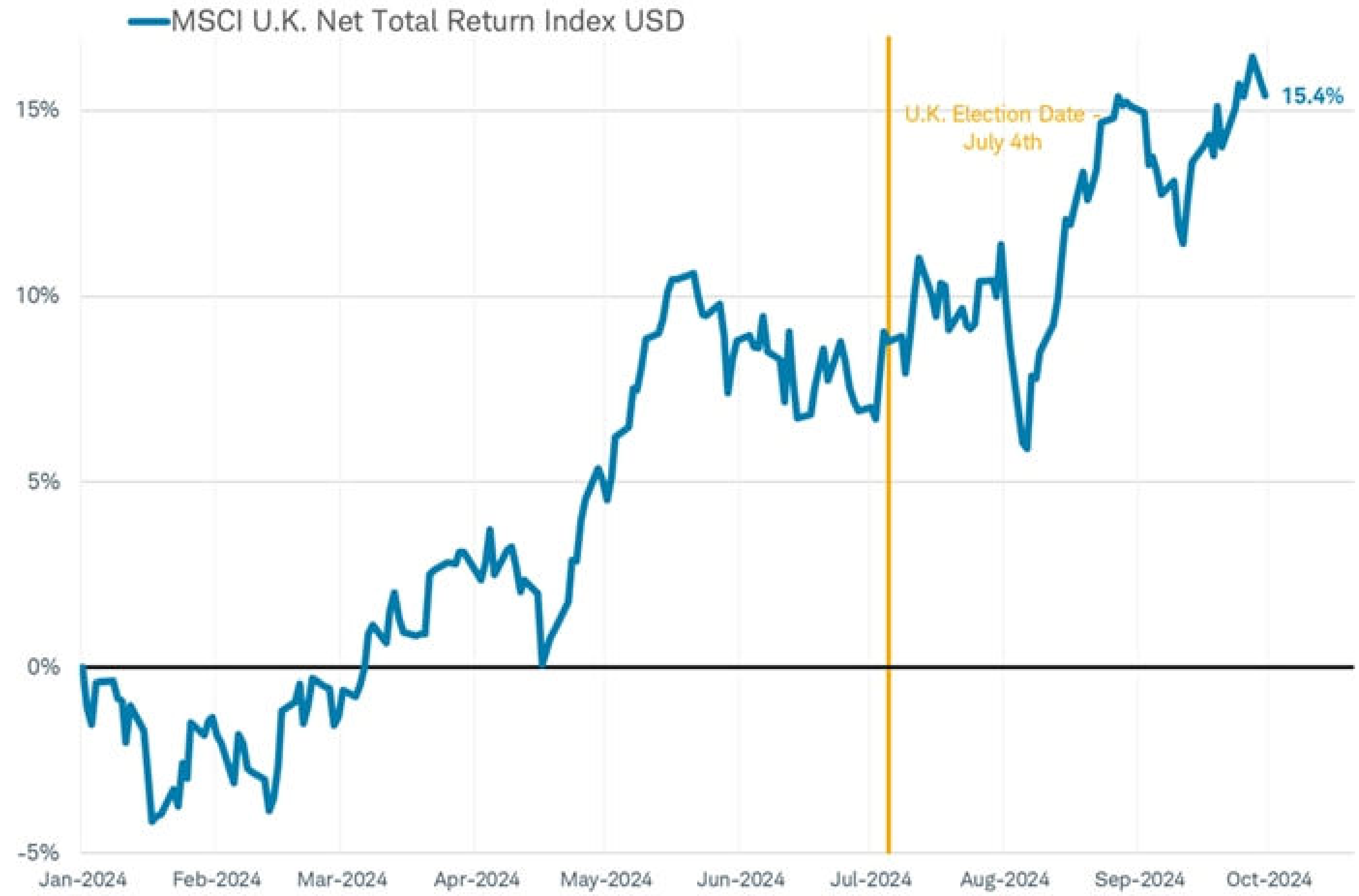
A broad theme that emerged across these elections: Gains were often seen by parties encouraging "my country first" nationalist policies that might restrict trade and touting fiscal-deficit-widening spending initiatives and tax cuts. These outcomes might have a negative impact on the markets given the potential impact on growth and inflation. But in general we have not seen changes in market trends following the election of new governments in Taiwan, South Korea, the Netherlands, Mexico, India, the European Union, United Kingdom, France, and now Austria. The major policy changes proposed by the winners during their campaigns saw little progress toward actual implementation, muting any potential market impact for now.

Instead, economic circumstances seem to have had a greater role in actual policy than the proposals offered by candidates:

- One of the earliest signs of this theme took place in September 2022, when far-right candidate Giorgia Meloni was elected as prime minister of Italy. Radical policies were expected to follow. Although Italian tariffs are set by the European Union, Meloni campaigned on distancing Italy from China in other ways, like withdrawing from China's Belt and Road Initiative, a major investment plan intended to deepen trade ties between the two countries. Yet, two years later, Meloni visited China to meet with President Xi Jinping this past summer, signing agreements boosting cooperation and deepening trade ties between the two nations. Italy's economic circumstances necessitated a more pragmatic approach to China trade relations, leading to much more China-friendly policies than implied by her campaign proposals.

- In the United Kingdom, the July 4 election gave the Labour party a large majority, ousting the Conservatives who had led the British government since 2010. Yet the potential for sweeping change and the implementation of new spending plans seems tightly constrained by fiscal realities that likely mean little near-term impact on policy and markets. As of October 1, the MSCI United Kingdom Index had produced a total return of 15.4% measured in U.S. dollars so far this year, seemingly unaffected by the changes brought by the election.

UK stocks in 2024



Source: Charles Schwab, Bloomberg data as of 10/1/2024.

The MSCI United Kingdom Index is designed to measure the performance of the large- and mid-cap segments of the UK market. Total return includes capital gains, dividends and interest. 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.**

The takeaway for investors from the many elections in 2024 is that actual policy may be more often dictated by economic circumstances rather than the proposals offered by candidates.