CHARLES SCHWAB

STOCKS

Schwab Market Perspective: Disinflation Risks

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Declining inflation has been a theme for the economy since mid-2022, but we still believe the road may have some curves.

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We think inflation will continue to trend lower, but there are a few potential risks on the horizon, including Federal Reserve interest rate cuts, stronger-than-expected economic growth in recent months, and policy proposals by incoming U.S. President Donald Trump that could raise tariffs or restrict labor supply. Despite Fed rate cuts, Treasury yields have climbed as investors consider the possibility of rekindled inflation.

However, the extent to which any policy proposals made during the campaign will become law is unknown at this point. And even in a hypothetical trade-war scenario that assumes permanent 10% U.S. tariffs on all imports, plus full-scale retaliation by Europe and China resulting in 10% tariffs on U.S. exports and also on all trade between China and the European Union, the International Monetary Fund has estimated a reduction of only -0.1% for global economic growth in 2025. It's certainly not enough to tip any major economies into recession next year.

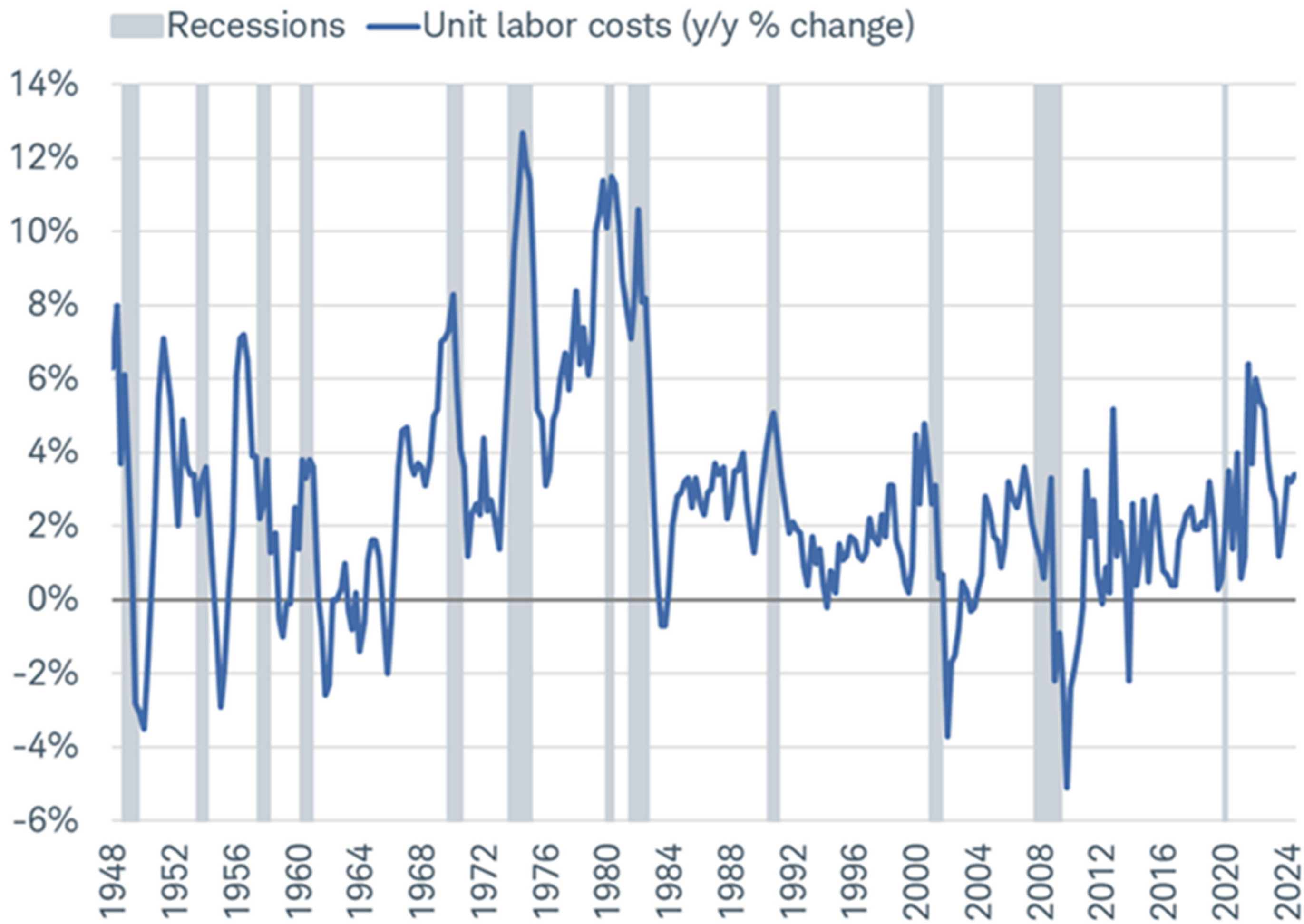
U.S. stocks and economy: Keeping an eye on reflationary impulses

One of the most constructive aspects of the post-pandemic recovery in the United States has been the relatively favorable disinflation trend ("disinflation" is when the pace of price inflation slows; it's different from "deflation," when prices actually decline). The peak in the Consumer Price Index (CPI)—in year-over-year terms—occurred in June 2022, at 9.1%. As of October, that rate was just 2.6%. The Federal Reserve's preferred inflation gauge, the Personal Consumption Expenditures (PCE) Price Index, peaked at 7.2% year-over-year in June 2022 and rose by just 2.1% year-over-year in September 2024 (the latest data available).

We continue to think the disinflation trend is strong for now but have consistently maintained (and still hold) the view that the path would be choppy. Looking forward, though, it's worth assessing potential risks to disinflation. Despite the U.S. policy outlook looking uncertain—not least because we're still waiting for a change in presidential administrations this coming January—there are policy proposals that aim to restrict labor supply. On top of potential tariff increases, this might be a source of more inflationary pressure, especially in pockets of the labor market.

So far, unit labor cost growth has eased considerably from its post-pandemic peak. However, as shown in the chart below, the annual change in unit labor costs climbed to 3.4% in the third quarter. That is near the upper end of the range over the past couple of decades.

Labor costs reaccelerating

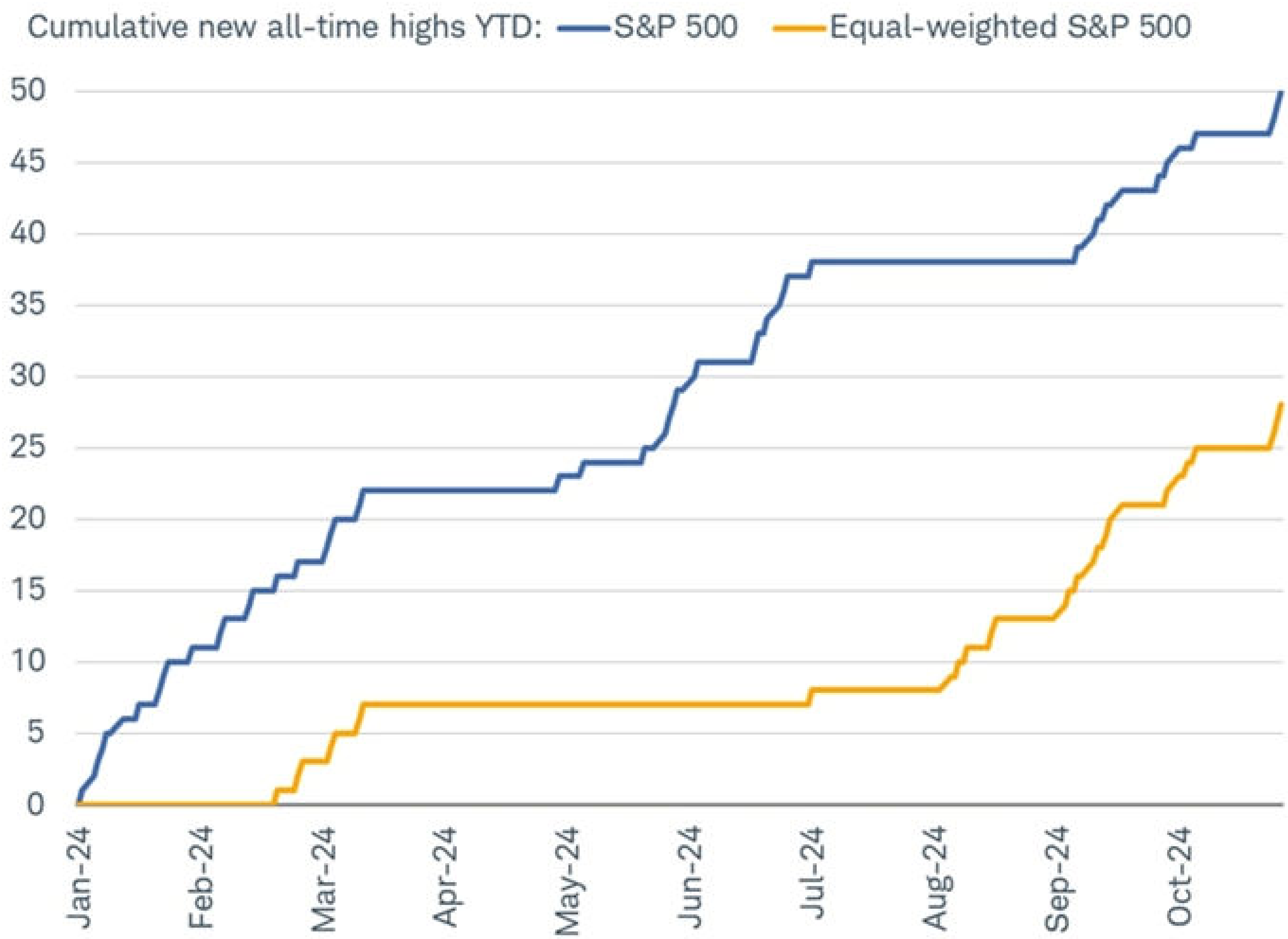


Source: Charles Schwab, Bloomberg, as of 9/30/2024.

It's too soon to say whether that uptrend will continue, but if labor supply is restricted and ends up putting upward pressure on wages, faster unit labor cost growth could unleash further momentum in inflation.

So far, the stock market has been largely unbothered by this, given the considerable number of new all-time highs for both the cap- and equal-weighted S&P 500 indexes this year.

New highs climb higher



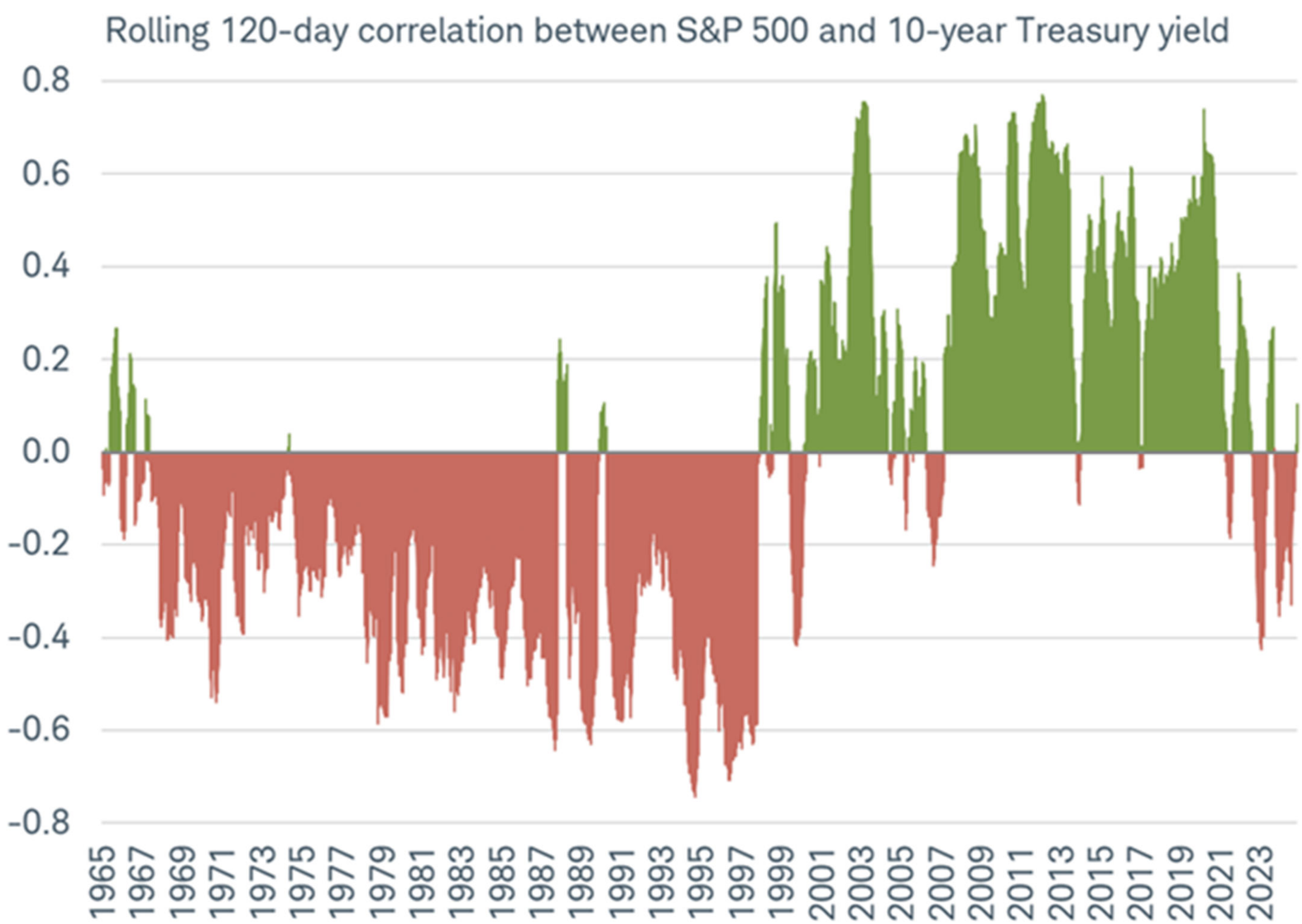
Source: Charles Schwab, Bloomberg, as of 11/8/2024.

Indexes are unmanaged, do not incur management fees, costs and expenses and cannot be invested in directly. **Past performance does not guarantee future results.**

However, we would put more emphasis on the relationship between stocks and bonds. Recently, the rolling 120-day correlation between changes in the S&P 500 and U.S. 10-year Treasury yield has turned positive, as shown in the chart below. That means the stock market is (for the most part) reacting positively to higher yields and stronger prospects for economic growth.

If the correlation flips back into negative territory, though, that would be consistent with inflation (again) being the main driver of downside risk for stocks. It's too soon to say that will be the case, but the risk is worth monitoring as we start to turn the corner into 2025.

Stocks and bonds getting along for now



Source: Charles Schwab, Bloomberg, as of 11/8/2024.

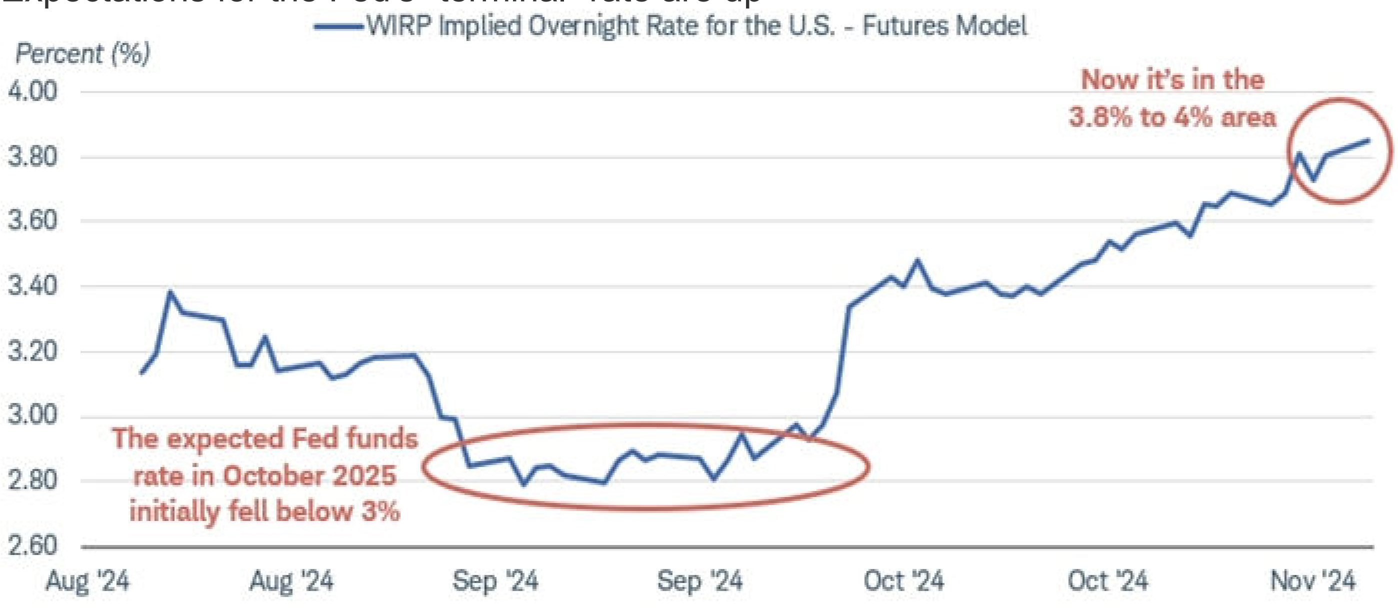
Correlation is a statistical measure of how two investments have historically moved in relation to each other, and ranges from -1 to +1. A correlation of 1 indicates a perfect positive correlation, while a correlation of -1 indicates a perfect negative correlation. A correlation of zero means the assets are not correlated. Indexes are unmanaged, do not incur management fees, costs and expenses and cannot be invested in directly. **Past performance does not guarantee future results.**

Fixed Income: Treasury yields on the rise

Bond yields have been on the rise despite the Federal Reserve's recent interest rate cuts. Concerns about a rebound in inflation on the back of stronger-than-expected economic growth since September, and the potential for expansive fiscal policy are the major drivers. Markets are beginning to dial back expectations for further rate cuts in response to inflation concerns.

So far, the rise in yields has been moderate over the past few months, but the pace has accelerated. Two-year Treasury yields are up by 65 basis points (0.65%) since the beginning of October, which is striking since the Fed has cut its base lending rate, the federal funds rate, by 75 basis points during that time. The increase in yields has pushed the "terminal rate," the rate where the cutting cycle is projected to end, up to the 3.75%-to-4.0% region, from less than 3% previously.

Expectations for the Fed's "terminal" rate are up



Source: Bloomberg, daily data as of 11/11/2024.

WIRP Implied Overnight Rate for the U.S. - Futures Model represents the estimated forward rate for the United States using the futures model. This ticker utilizes "virtual ticker" technology to show multiple dimensions of data via a single ticker. By default (without a virtual component added) the ticker always references data for the upcoming meeting of the country under analysis. Once a meeting passes, the ticker then rolls to the next meeting.

Ten-year Treasury yields have moved up by about 70 basis points since September. Much of the increase is due to the strength in economic growth. After a decline in the summer, economic data have been surprisingly strong. Estimates of growth and employment in Q2 were revised sharply higher in the fall, sending yields up. Employment growth and consumer spending were the main reasons that GDP growth rose at a solid 3% pace for the last three quarters.

Economic momentum was likely a driver of higher yields

Source: Citi U.S. Economic Surprise Index (CESIUSD Index) and US Generic Govt 10-year Treasury. Daily data as of 11/11/2024.

The Citi Economic Surprise Index measure data surprises relative to market expectations. A positive reading means that data releases have been stronger than expected and a negative reading means that data releases have been worse than expected. **Past performance is no guarantee of future results.**

Stronger growth suggests that the Fed may not lower short-term rates as much as anticipated just a few months ago. Adding to the shift in the view of Fed rate path is the likelihood of higher inflation under proposed policies from the incoming administration. Tariffs, tax cuts and immigration reform were the cornerstones of president-elect Trump's campaign platform. Tariffs tend to act as a one-time price increase as the costs are passed from importing companies to consumers. Similarly, tax cuts have been proposed that could provide more stimulus to an economy already growing at a healthy pace. Immigration reform could mean higher labor costs.

It is far too early to know what specific proposals, if any, will get enacted. Moreover, some of the policies could have negative effects longer term, as tariffs and a reduced labor force could limit growth and investment. Tax cuts are stimulative but add to deficits and the accumulated debt load. Higher deficits may mean long-term yields have to rise to attract more buyers to the Treasury market.

We expect the Federal Reserve to continue with rate cuts over the next few months if inflation continues to trend lower. However, we are assuming a slower and shallower path of rate cuts in 2025 than we did just a month ago. Fed Chair Jerome Powell indicated that, for now, the Fed will focus on the current information it has, which still shows room for a decline in the federal funds rate toward 4%. However, it will be attentive to the emerging policy shifts that could tilt the inflation outlook to the upside. Consequently, intermediate- to long-term rates have the potential to move higher from current levels.

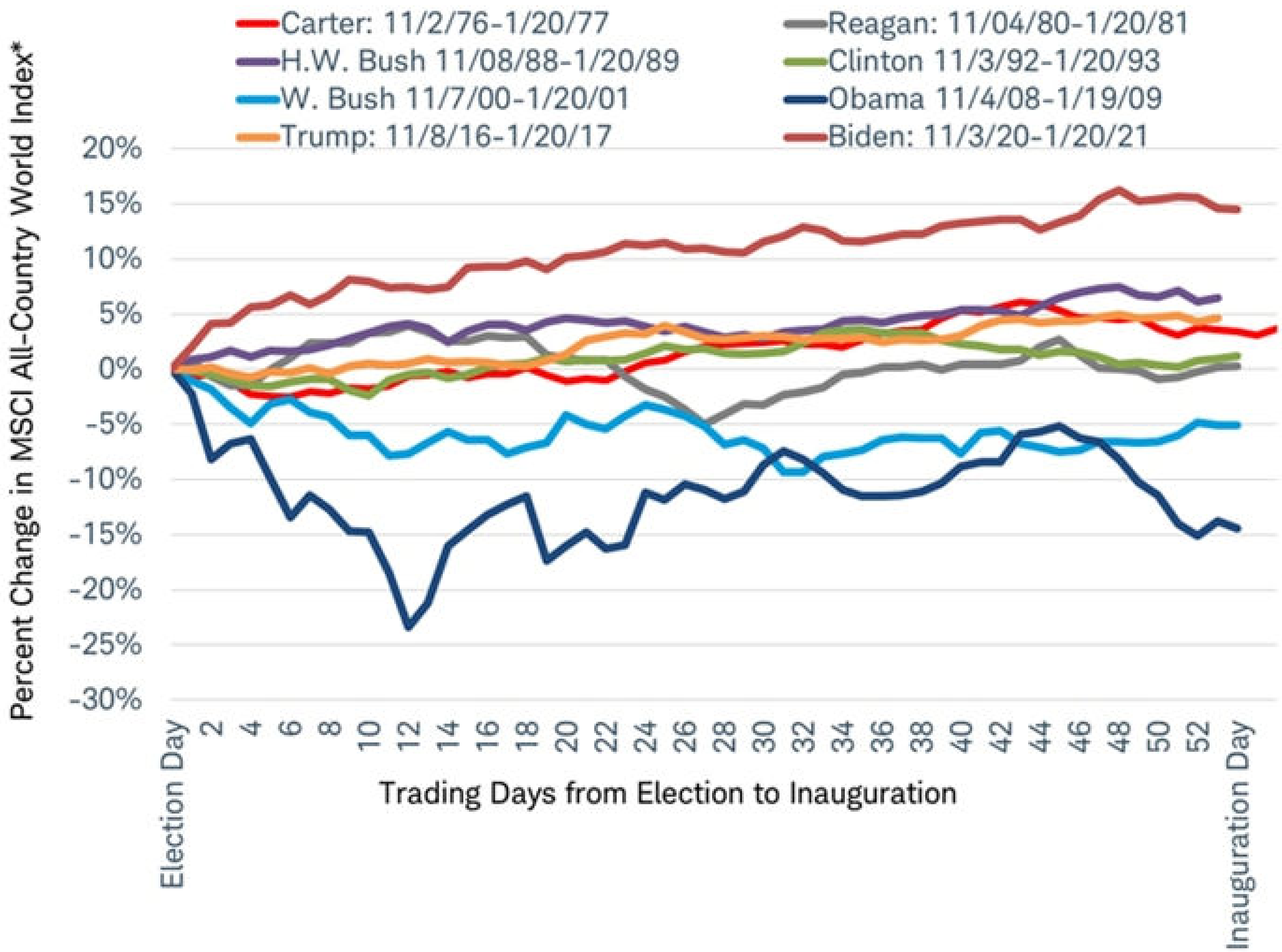
We suggest investors maintain a benchmark duration or lower. We use the Bloomberg Aggregate Bond Index as a benchmark. It currently has a duration of about 6.2 years, but individual investors should consider what is appropriate for their own portfolios in view of the risk of higher interest rates.

Global stocks and economy: Transition period

Incumbents suffered this year after the biggest surge in global inflation in decades. In this significant election year—with more than half of the world's population voting—new governments were formed in Taiwan, South Korea, the Netherlands, India, the European Union, the United Kingdom, France, Japan and the United States. A reminder: Economics usually have more of an impact on elections than the other way around.

Stocks are off to a typical post-election start, with gains in the global stocks that make up the MSCI All Country World Index. Despite changing parties and policies, the only two negative presidential transition periods for global stocks (the approximately 54-trading-day period from U.S. Election Day to U.S. Inauguration Day) in the past 50 years were during the recessionary bear markets of 2000-2001 and 2008-2009. We expect continued, though subdued, economic growth heading into 2025, similar to transition periods that featured gains for stocks.

Performance of MSCI All-Country World Index from U.S. Election Day to Inauguration Day



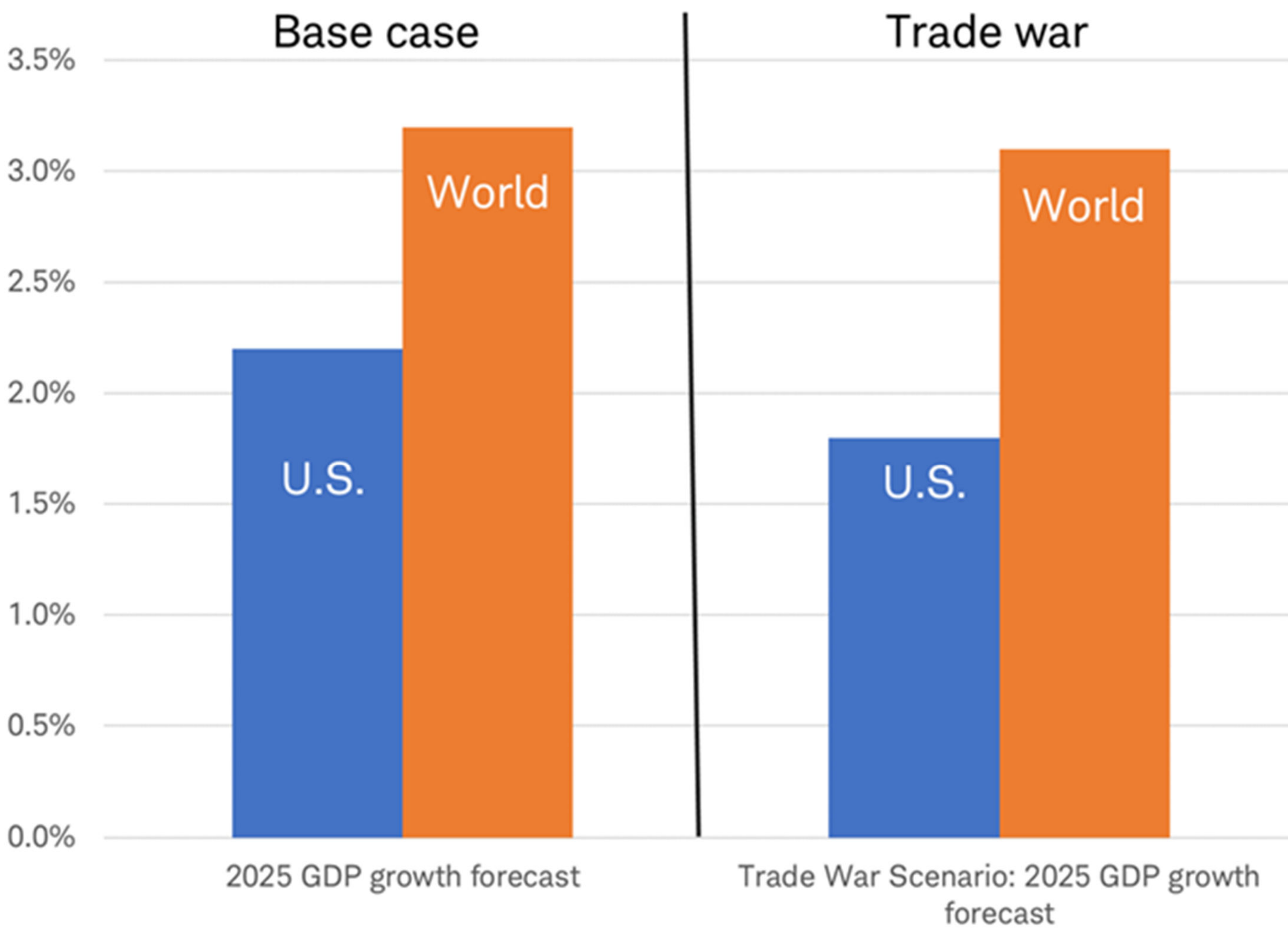
Source: Charles Schwab, Bloomberg data as of 11/5/2024.

*MSCI All Country World Index used for all periods since its inception in 1987, and MSCI World Index is used for prior periods (1976, 1980). **Past performance is no guarantee of future results.** Indexes are unmanaged, do not incur management fees, costs and expenses and cannot be invested in directly.

Exceptions to the post-election gains during this transition period so far can be found in Chinese stocks and those of German automakers—both likely to be a focus of any U.S. trade pressure. The prospect of additional tariffs on the rest of the world in a second Trump administration poses downside risks to economic and earnings growth, as well as upside risk to inflation, but the impact may be modest.

The latest World Economic Outlook from the International Monetary Fund (IMF) was published in late October and took a deep dive into the growth and inflation impacts of a potential trade war in 2025. In a hypothetical trade-war scenario that assumes permanent 10% U.S. tariffs on all imports, plus full-scale retaliation by Europe and China resulting in 10% tariffs on U.S. exports and also on all trade between China and the European Union, the IMF projects the tariffs would result in a reduction of only -0.1% for global gross domestic product (GDP) growth in 2025, lowering the base-case GDP growth forecast to 3.1%. The estimates include a larger, but still modest, -0.4% hit to U.S. growth, along with negligible drags on Chinese and European growth in 2025.

Forecasted GDP impact from potential trade war



Source: International Monetary Fund World Economic Outlook, as of 11/6/2024.

The IMF trade-war scenario assumes a 10% across-the-board tariff on all U.S. imports and full-scale retaliation by all countries. This hypothetical example is only for illustrative purposes.

When accounting for a related increase in trade policy uncertainty, the IMF finds that the impact would be a slightly larger drag on GDP. Even so, this would not be anywhere near enough to tip any major economies into a recession in 2025, according to IMF estimates. That may be important to keep in mind if some affected companies grab headlines with dire warnings.