



The Latest Threat to Fed Independence

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KATHY JONES: And I'm Kathy Jones.

LIZ ANN: And this is *On Investing*, an original podcast from Charles Schwab. Every week we analyze what's happening in the markets and discuss how it might affect your investments.

Well, Kathy, we've said this often, but yet again, no shortage of things for us to talk about this week.

KATHY: That's for sure.

LIZ ANN: Well, unless you've been living under a rock, everybody now knows that the U.S. Attorney's Office in the District of Columbia has opened a criminal investigation into Federal Reserve Chair Jerome Powell, supposedly over the central bank's renovations of its headquarters and whether Powell lied to Congress in testimony last year about the project.

Maybe most interesting was how hard Powell immediately pushed back on this posting a video where he explicitly said this is really about putting political pressure on Fed independence and its ability to set interest rates. So once again, we find ourselves in uncharted territory here. Bond market has been somewhat calm through this. So let's start there. What do you make of all of this in general, but also from the perspective of the bond market?

KATHY: Yeah, the bond market is really sort of snoozing through everything these days. It's been remarkably calm. We've had yields pretty much across the yield curve for Treasuries in a very narrow range for well over a month or so, and really over the last couple of months haven't made any real dramatic moves. I think it reflects the fact that, although all this is going on, market doesn't really believe that there will be a substantial change in Fed independence, that the Fed will prevail in terms of setting policy as they see fit, which already includes the prospect of further rate cuts. So it's not like the Fed has been raising rates or denying the willingness to

raise rates. It's just that, apparently, it's not moving as quickly as the president would like.

But at the end of the day, I don't think the market buys any of this is going to have a big impact. So we will have to see, of course. You know, clearly, Fed Chair Powell put out the video to defend his reputation. It's one thing to be criticized for your policy decisions. It's another thing to be accused of lying to Congress and impugning your integrity. So I think that that's probably the line that was crossed.

And there was, apparently, Representative French Hill from Arkansas, who's on the House Committee for Financial Affairs—I think it's what it's called—referred today to the empanelment of a grand jury. So apparently there's a lot of stuff going on there. It also may, interestingly, prevent Powell from making his Humphrey-Hawkins testimony. Twice a year the Fed chair is compelled by Congress to go in front of Congress to testify on monetary policy. And that's typically done in February and then again later in the year. But apparently there is a restriction that if someone's under indictment that they can't do that. So we may get even less information from Powell.

And it runs against, you know, what Congress's desire was when they set this up is to have the public hear frequently or at least regularly from the Federal Reserve about policy. So that leaves us with, perhaps, even less clarity going forward than we had. But again, I think the bond market's just looking at it and saying, "You know, at the end of the day, the economy seems to be running along OK. Inflation is gradually coming down. It's still stuck at too high a level, but everyone agrees there's likely to be at least one or two rate cuts. And that's leaving the bond market at a pretty complacent spot at this stage of the game."

I worry about that complacency because it's already been a long year, and it's January, mid-January. So I worry that the market's a bit too complacent about the things that are going on and the risk to the economy, risk to inflation, etc. But it's the collective wisdom of the market right now is that all this is just noise and, you know, we'll kind of come through it without any major shifts in what's going on. Well it remains to be seen, but I don't remember when I've seen such an international coalition coming together to support someone at the Federal Reserve, you know, you had people weighing in from all kinds of central banks all over the world, supporting the independence of the Fed.

So it clearly resonated with policymakers, but, you know, talk to me a little bit about some of the other things going on, Liz Ann, that are or are not affecting the equity markets. We've got Venezuela, seems to be ignored right now. But conflicts really sort of all over the place.

And then we got some data on inflation, affordability is a big question mark right now that a lot of people are talking about. And it looks like the stock market is kind of just a little queasy but not really rolling over here.

LIZ ANN: Yeah, certainly not in the aggregate, although we are seeing pullbacks in some areas that had maybe been representative of prior darlings within the market. Still some concern about valuations in the kind of tech world. The so-called Magnificent Seven, which is now the "Mag Two" and the "Lag Five" really, given that we're not seeing aggregate outperformance there anymore. But you know, to your point, Kathy, about the economy in decent shape. I think that is picked up by what has been happening inside the stock market. So the fact that recently you hit a point where the basic materials sector had all stocks within that sector trading above their 50-day moving average, so very technically strong. You've seen the strong performance out of industrials.

And that's kind of interesting because when we look at things like the labor market data, not just the most recent jobs report that came out for December, but broader labor-market data, most of the strength in things like hiring and payrolls has been in those non-cyclical parts of the economy. So healthcare and education and leisure and hospitality, and where there's been weakness in terms of payrolls is in those more cyclical areas like transportation, warehousing.

So the message coming out of the stock market versus the message coming out of the labor market is a little bit different. Some of it might be explained by virtue of the fact that a lot of labor market data, certainly payrolls and definitely the unemployment rate, are a little more lagging in nature. Payrolls are considered a coincident economic indicator and then the unemployment rate is considered a lagging economic indicator, where the stock market is considered a leading indicator. So all else equal, I would say the message from the stock market is one to heed about continued resilience in the economy.

The Venezuela situation, again, fairly calm action on the part of the stock market, as you know, because you were part of the collective thinking that went into the note that we put out a week ago, Monday, in the immediate aftermath of the events unfolding in Venezuela. It is not abnormal to see a little bit of a spike in volatility short term, but not a long-lasting impact unless it either works its way sustainably through the energy channel, such that you get ongoing high oil prices that then threatens economic recoveries or even helps to bring on recessions. That doesn't appear to be in the near-term cards.

I do think the stock market, particularly recently, continues to key off what's going on in your world in the bond market, and the relative calm there and the stability in

things like the 10-year yields is part of the reason why I think the stock market has been able to generally ride through a lot of this instability, uncertainty, without too many feathers being ruffled.

You know, we're in an interesting point here now in the stock market because earnings season has just begun. As is always the case, it's some of the major financials that report initially. A little bit of a mixed bag, generally better than expected readings, but what we're already starting to see is even slight misses, either on top-line growth or bottom-line growth estimates, or both the stocks are getting somewhat disproportionately hit relative to the benefits that are accruing to stocks of companies that are outperforming expectations. Way too early in the earnings season to say that in any kind of aggregate way, but that's in addition to always watching the trajectory of earnings and beat rate and percent by which companies are beating. It's market reaction that I'm keeping a close eye on as we traverse through earnings season. Again, continue to think that action or lack thereof in the bond market has been part of the reason why the equity market has generally been fairly stable.

Interesting rotations continue. I already mentioned the relative underperformance, at least in the aggregate of the Magnificent Seven, even shift within that cohort with Amazon more recently being the best performer among them. And also interestingly, Amazon has recently become the number one contributor to S&P returns on a year-to-date basis, but it's not even ranked in the top 100 within the S&P in terms of price performance. So I want to continue to point out that there is a difference between where you rank in terms of contribution to return and where you rank in terms of price performance, and the difference being the multiplier of the cap size.

It's also the case that NVIDIA, which had been the number one contributor to S&P returns last year, I recently looked at it, and it's the 500th-ranked contributor now because it's had underperformance from a price perspective multiplied by its giant cap size. So it works in both directions. In fact, last time I looked and this might be a day old as of this point, plus we pre-record, so I'm not going to provide precise numbers because our eagle-eyed people who are keeping track of this, as we do on a day-to-day basis, might once this is actually airing say that's not the case anymore. So I get that. But last I looked, four of the Magnificent Seven were ranked in the lower-most decile in terms of contribution rank. They're not disastrous performers, but again, when you multiply underperformance by giant cap size, you get a contribution rank that looks entirely different than a performance rank. And that's just something we want to continue to remind investors of because I think often they conflate contribution to cap-weighted index returns with how the stocks are

doing. And those are not one and the same. So that's something that has been on my radar.

KATHY: So Liz Ann, I wanted to ask you about the housing market, because I know you follow that closely, and we recently had the news where the administration has asked the agencies that buy mortgage-backed securities to increase their purchases by \$200 billion. That would be Fannie Mae and Freddie Mac.

We've got some housing numbers out this week on existing home sales. What do you think this does for the mortgage market? I would argue you still need Treasuries to come down quite a bit to get significant progress here, but ... and there's a whole question about whether the agency should be ramping up their activities again when they were just told to ramp them down after the financial crisis, so leave that all aside in terms of the housing market. Where do you see that going these days?

LIZ ANN: Yeah, and you're right, there is data coming out. We've got home sales, we've got building permits and housing starts, as well as the Housing Market Index, the HMI, which is put out by the National Association of Home Builders. It's kind of a broad aggregate sentiment index. It's what home builders are expressing. So that's usually probably the single point proxy for the health of the housing market, but specific to mortgage rates.

Looking at mortgage rates alone, I think it would take a lot more on the downside to really provide some juice into the housing market because the affordability problem, which we talk about a lot more broadly in the economy, has been an ongoing problem within the housing market. And there's three legs to the affordability stool, mortgage rates being one of them. The other one is our own income, our after-tax income. That's been generally somewhat supportive, but it's home prices. And we still have a significant supply-demand imbalance, especially in the existing home market. And that's in part because even though mortgage rates are down a little bit, they were high at a point where they weren't actually having a significant impact in freeing up the existing mortgage market because a lot of homeowners that had mortgages took advantage of the kind of post-COVID, 0% interest rate, 10-year bottoming at less than 1%. And they termed out mortgages, and they went from variable-rate mortgages to fixed-rate mortgages. And at the high in the mortgage rate, which I think was at the high rate around 8% in the 30-year fixed mortgage rate?

KATHY: In this cycle? Yeah, yeah.

LIZ ANN: Yeah, and at that same time, you had a 3 handle on the actual average mortgage rate held by homeowners. Now that has started to trend higher because maturities happen, and sales do happen, but there still is a gap such that you're not really seeing a significant freeing up on the existing side, and there just has been a dearth of new build.

So we still have that supply-demand imbalance, which means prices are still quite high. And it's one of the reasons why, if you look at a chart of the average age of first-time home buyers, that's been going up significantly over the last 10 years or so. So I think the affordability problem is not just a mortgage rate problem; it's a home price problem. And it's just a general confidence problem because it's part of the whole angst about affordability that works its way into psychology, too.

So I think it's going to take a lot more. We probably have seen the worst in terms of various statistics on the housing market, but I don't anticipate that we're at some inflection point where things are going to dramatically improve, barring a really significant drop in the mortgage rate. But of course, the conditions that might drive that would probably not be great economic conditions.

So you know, be careful what you wish for if you're hoping for a significant plunge in the 10-year, which would lead to a significant plunge in mortgage rates. The economic backdrop associated with that is probably not hunky dory, to use a technical term.

KATHY: Right. Well put. Honky dory, it reminds me of my Midwest upbringing.

LIZ ANN: We're showing our age, too.

KATHY: Yes. Yes, indeed. So OK, so we've talked about consumer prices. Those came in sort of OK. I think there's just a difficulty getting momentum on the downside in inflation. So ...

LIZ ANN: Yeah, and producer prices, as we're taping this, we just got the Producer Price Index, and that was hotter than expected. That tends to be more volatile, and it's not the Fed's so-called preferred measure, but it's another place you can look and point to where inflation is just not near the Fed's 2% target.

KATHY: Yeah, and not moving in that direction. And I think that's the more difficult part for the Fed to say. And they do have the projection, but now it's two years out, as it always is, to get to the target. And they need to see some progress in that direction, I think, to convince several people at the Fed that it's time to cut rates again.

LIZ ANN: Yeah, and it doesn't look like there's really any chance that the Fed's going to cut at the January meeting.

KATHY: I think that would be awfully tough in this charged political environment for them to make that decision.

LIZ ANN: Not to mention that neither side of their mandate is screaming that they should be easing policy here.

KATHY: Exactly. I mean, that's more the point. You know, they're paid to do the math, and the math is saying unemployment rate is still low, and even though job growth is soft, you know, you're not seeing a spike in unemployment, and inflation is not where they want it to be, and doesn't seem to be moving very quickly in the right direction. So what's the point? Yeah, I agree with you.

LIZ ANN: So Fed, yet again, has sort of put themselves in the timeout box for the time being.

KATHY: So Liz Ann, we have a shortened week because of the Martin Luther King Day holiday. Is there anything you're looking at for next week that's really important?

LIZ ANN: Yeah, so we did, obviously, just recently get the December jobs report, but given that it's still kind of muddy data, and we still have the absence of one month's unemployment rate a couple of months ago, I think parallel labor-market data continues to be really important. Not just the traditional data like unemployment claims—that's always worth watching, especially the spread between initial claims and continuing claims—but ADP, even though it doesn't represent as a proxy for the Bureau of Labor Statistics payrolls, they're now releasing weekly data. So it's yet another data point we can look at in parallel fashion to other labor-market data. We already touched on the housing-market data that is coming out. And then next week, we'll also get the Personal Consumption Expenditures index, another measure of inflation, and that is the Fed's so-called preferred measure. So keeping an eye on that. How about you?

KATHY: Yeah, the Beige Book is due to come out, which I think is always important. This is a book that's kind of prepared for the Fed meetings. And we get it with a delay, but it helps you sort of parse together how the Fed is looking at the economy based on the regional Fed bank reports. So that's going to be important. Of course, there's a raft of Fed speakers every single day.

And we'll get the range of views there, but it'll probably ... I'm guessing those speeches will tell us that the hawks are still hawks, the doves are still doves, and

there's still a few people kind of in the middle. I don't know that it'll be revealing, but you never know. Sometimes they switch sides, and it's a surprise. So I'll be keeping an eye on that.

LIZ ANN: Well, that's it for us today. We're so grateful that you continue to tune in. So thank you again. And as a reminder, you can keep up with us in real time on social media. I'm @LizAnnSonders and on X and LinkedIn. Although the imposter problem is getting marginally better because we have a team of people at Schwab playing whack-a-mole. But still, make sure you're following the actual me, as I do still have them from time to time.

KATHY: And I'm @KathyJones on X and LinkedIn, and that's Kathy with a K. And you can always read all of our reports, including lots of charts and graphs, at schwab.com/learn.

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