Mixed Signals & Moving Targets

LIZ ANN SONDERS: I'm Liz Ann Sonders.

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, hi, Kathy. It has been a shorter week, thanks to Presidents Day, on Monday. We did get some inflation data that came out a little cooler than expected at the end of last week. But we've had lots of mixed signals in the economy. And then as you and I are taping this, we got the Fed minutes just a couple of hours ago. So maybe in the context of broader trends around the labor market and inflation, add in your thoughts on what we heard out of the minutes.

KATHY: Yeah, I thought they were pretty interesting. So we all know that they didn't take any action and that the committee has been divided for a while about which way to go. But I thought it was notable that "several"… so these words are important—"some," "several," "many"—these are all kind of code words for how many that means, how many people that means. But several people were noted wanting to shift to a two-sided way to describe the Fed's outlook, meaning we might hike, or we might ease. And I think the market, after that cool inflation number that we got, was really poised for more rate cuts. It really kind of moved short-term rates down in anticipation of rate cuts.

And I think that has to be reconsidered, because if several people are taking the view that "Well, maybe we'll go up, and maybe we'll go down," I don't think it's a done deal by any means that there's going to be some rate cuts. And probably the other interesting part was the description of the labor market that most of the participants at the meeting were of the opinion that the labor market has stabilized. Now keep in mind that the reason the Fed cut three times last year was because they were concerned about the labor market.

So if the belief is, by the majority at the Fed, that the labor market is stabilized, that's another argument for just sitting still and not doing anything. I don't think the market is correctly priced for that outcome. And it certainly says to me that Kevin Warsh, assuming he becomes the next Fed chair, will have his work cut out for him, trying to unite this committee around a single point of view.

So I'd love to get your thoughts. We've got a lot of other economic data, but I'd love to get your thoughts.

LIZ ANN: Yeah, you know, I also think even though, and maybe this is good news, we don't have Fed independence concerns as front and center as we did even a few weeks ago, but in the last six months or so, and I continue to think that whether it's more dissents, whether it's a wider spread in terms of the opinions of various Fed members and how they're expressing them, what we saw in the minutes out this week, I think, is a good news story, given that it helps to alleviate some of those concerns about Fed independence, because it suggests that they're not a bunch of lemmings that are just going to blindly follow, certainly not follow politicians, but potentially Kevin Warsh if he's seen as being swayed politically.

So that's not a bad thing. But the economic data continues to be a little bit mixed. In some cases, like with some of the industrial data that we got out this week, you had better-than-expected readings, but downward revisions to the prior months. And that's still another force that we're dealing with, which is just a lot of volatility in the economic data and revisions that can sometimes be significant, not to mention some recent attention on the household survey, which is the survey from which the unemployment rate is calculated, and the pretty dramatic decline in the response rate to that survey.

Our guest in the past, the well-known Claudia Sahm, has been on social media quite a bit highlighting that response rate, and that continues to infect not just the household survey out of the BLS, Bureau of Labor Statistics, but a lot of other survey-based data. But we continue to see an ongoing disconnect between the soft economic data and the hard economic data, the soft economic data being survey-based data, where there you see much more nervousness, pessimism, sort of dour views relative to the harder economic data that continues to be relatively strong. And that's in keeping with the Atlanta Fed's GDPNow. We will be getting in short order the actual GDP readings for the fourth quarter, but we continue to see what used to be described as a bit of a jobless recovery. And in my mind, more likely than not, that will persist. But it's also interesting that some of these divergences are happening in the market as well.

You're seeing a ... kind of the tails really expand in terms of stocks that are doing particularly well, stocks that are not doing well. There's a very wide spread between the best performing stock in the S&P this year and the worst performing stock in terms of performance spread. You also have a pretty significant jump in the percentage of stocks on a year-to-date basis that have moved into technically overbought territory, but a similar jump in the percentage of stocks that have moved into technically oversold territory. So a lot of dispersion within the market, even within cohorts like the Magnificent 7. I continue to think that some of these rapid-fire rotations are likely to persist. Some of it is a function of the story around AI. And when we bring Kevin in momentarily, I want to talk to him a little bit about that.

We just wrote a piece, our latest piece on AI, and what we think of as the three C phases: the create phase, which is the large language models and the hyperscalers, and then it became the catalyzed phase, which is the build out of AI into data centers and energy uses. And that gave kind of a lift and the start to the trade that has been very biased toward industrials and materials and the energy sector. And now we're kind of in the cascade phase where we're ... everybody is trying to figure out who are the beneficiaries of AI as it cascades through the economy, but who's also being disrupted.

And boy, we're seeing rapid-fire shifts in areas that are displaying strength and weakness driven by, "OK, who's the next area to be disrupted? Where are the beneficiaries?" And so we kind of have this swirling market where a lot of the money has a short attention span and tends to jump from shiny new object to dull new object to shiny new object. And it makes it a little bit more difficult for investors to try to navigate. But we always go back to the tried-and-true disciplines around diversification, especially in an environment like this.

KATHY: Yeah, we've been seeing a little bit on the fixed-income side. You know, some of these companies are now floating a lot of debt to finance their capex, and that's created some concerns. It hasn't really reflected in the credit spreads, so those are still very low because a lot of, certainly in the investment-grade area, those companies are still in great shape with good balance sheets, and it's not that important. What we're seeing, though, is in the leverage-loan market, I think, in private credit, there's a lot of concern about too much leverage in this area to catch up. You see these companies trying to catch up with each other, right? So going to have to see how that plays out.

The other question I had, do you happen to know, or maybe this is good question for Kevin, how much of GDP growth has been driven by this capex?

LIZ ANN: Hold that thought, we'll ask him when he joins us in a minute. One other thing I wanted to touch on, too, is, you know, I think generally everybody thinks of the S&P 500® as the proxy and the benchmark for the U.S. equity market. It is, though, interesting that the Dow especially, the Dow Jones Industrial Average, especially when it crosses these, you know, thousand-point increments, especially when they round to the 10,000 like the recent passage of the 50,000 mark, it brings it into attention. But I've been getting a few more questions about it recently. "What explains the outperformance of the Dow in an environment like this?" And it's actually fairly simple, given that the Dow is not a cap-weighted index. It's a price-weighted index, and it has less exposure to the tech area broadly, the whole tech atmosphere, inclusive of things like communication services. So when you have some combination of industrials, some of the defensive areas with consumer staples having done well more recently, tech's relative underperformance on a year-to-date basis, and that is where many of the largest-cap stocks are, and they reside in that cap-weighted index that's the S&P, that's the very simple but easy to understand explanation for why maybe the Dow is back in the spotlight a little bit.

So as we mentioned, I want to now bring in our colleague Kevin Gordon to discuss a whole bunch of things. Kevin is the head of macro research and strategy here, global macro research, I should say, and strategy here at Schwab. And he's been a guest on the show many, many times.

Kevin, first of all, thanks for joining us as always.

KEVIN GORDON: Well thanks for having me back, always good to be with you.

LIZ ANN: And let's start with where Kathy and I just left off talking about the backdrop from a macro perspective, the latest data on inflation and the labor market, and some of the mixed signals that continue to exist inside the economic rating. So how do you stand, especially as we approach the release of fourth-quarter GDP?

KEVIN: Yeah, well, to the question that Kathy had around how much of GDP growth has been driven by, you know, specifically capex in the AI space, I mean, there's not a specific … for those who follow GDP, there's not a specific AI carve-out component as you know, but we can kind of proxy it if you want to look at, you know, business investment and specifically within it everything in the tech space related to hardware and software and computer equipment. So there's a couple of ways to look at it.

You could look at the actual contribution to GDP and take the percentage of it that was driving overall growth, and then the first and the second quarter of last year,

that's when the spike was the most pronounced. So that's when all of those tech-related components had, you know, the largest contributions since the late '90s and the early 2000s. And there was kind of this myth at the time that if you took everything else out, then it was just that, and that was the only thing that was driving GDP, which is, as I said, it was a little bit of a myth. It's not entirely true because consumer spending was still growing, even though it was slowing. And you had a lot of distortions from the net exports component, given everything that was happening with trade. So it's almost a "two things can be true" situation where, yes, you had these near-record contributions from everything in the AI world, but it was not the only thing that was driving growth.

So I think that, to the extent we want to look at the labor data and the revisions that we got, especially the annual benchmark revisions for payrolls in 2025, and you look at how weak we were, especially getting into the end of 2025 in terms of the overall labor market and the hiring space, it's probably safe to say that consumption didn't end in a very strong way last year. So I wouldn't expect the whole picture to change in terms of business capex kind of carrying the economy and then the labor market, and in particular consumer spending not being as strong as it once was. So I think that when we get fourth quarter GDP, we don't have it in front of us yet when we're recording this episode, but that to me, I think, is a really important thing to look for in terms of the slowdown in the momentum for something like consumer spending.

Because I think, at first glance, it could look concerning, but at same time, looking at that in the context of a labor market that did slow materially last year, I think it would make a lot of sense. And there are, as you and Kathy were talking about, especially in the eyes of the Fed and how they view some stabilization as we've turned the corner into 2026, there are some signs of stabilization. If you look at the private workforce, that payroll growth has leveled off, and it started to accelerate a little bit. We know that a lot of the weakness in the government workforce last year was driven by the cuts from the Department of Government Efficiency. So there are certainly … I wouldn't call them green shoots. Maybe I would call them light green shoots. I don't know. I have to come up with another color. But I think for labor, there's just signs that we're sort of pointing towards this more stable backdrop, not anything consistent with a boom.

So I think that's what keeps probably the consumer spending data just a little bit softer for now. And fortunately, or unfortunately, depending who you are in the economy, what actor you are in the economy, we still have the business investment component that's been driving a considerable amount of growth.

LIZ ANN: Yeah, let me pull on a couple of threads there and bring tariffs into the mix. There's been some attention recently on data that's coming out suggesting that companies have been able to hold off on a significant pass-through of tariff costs onto the end consumer by virtue of several things.

One, in the aftermath, the multi-month aftermath of the April 9 announcement last year of the 90-day delay of the reciprocal tariffs that had been announced a week before. What we know is that companies did a tremendous amount of front running and ordering of imports, so they built inventories at a low cost basis. And then helping to explain this low-hiring, low-firing kind of backdrop, we also know that many companies either opted not to hire, or they actually shed some workforce as a way to protect margins.

But now there's stories about we're kind of at the cusp of another wave of pass through. So how do you think about the tariff impact? There are certainly camps that believe that the impact is fully behind us from an inflation standpoint, but what are you thinking about tariffs impact and whether there's validity to that concern that companies are poised now to start to pass on some additional costs

KEVIN: Yeah, this is always such a struggle to, I think, sift through because you often hear, if you look at the aggregate inflation data, so if you look at the Consumer Price Index, the CPI, or if you look at the Personal Consumption Expenditure price index, the PCE, which is the Fed's preferred metric, if you look at those at the headline levels, they're actually diverging right now. So the PCE is a little bit more elevated than CPI. But overall, you can look at the behavior of those indexes over the past year, and you could say, "Wow, there's really hasn't been a ton of inflation pressure from tariffs. Everybody who projected that was wrong."

But if you look under the surface of those indexes, and you specifically look at the goods components of them, so there was certainly pressure last year, upward pressure on goods prices. in January in particular, within CPI, I call it core-core goods, because it takes out energy, but it also takes out used cars and trucks.

That component was actually incredibly hot in January when we got the CPI report. And it's interesting because January is always a funky month for data, especially for CPI and for the jobs report. But when you look at some of the pretty significant increases for the core-goods component, it was a little bit worrisome from the standpoint of those who were expecting a bigger tariff pass through, for that to start kicking in, especially because, at the beginning of the year is when companies tend to initiate their pricing hikes for the coming year. You tend to see that show up in January. So you had this really interesting dynamic where goods inflation was relatively hot, but everything else was sort of working in your favor, shelter

inflation. You know, we saw disinflation again. You had seen, you know, some aid from part of the services, you know, economy, aid in terms of, you know, disinflation, so working in consumers' favor.

But it is going to be an interesting exercise this year if we do start to see that pass through because the goods component of CPI or PCE is smaller than services. So to the extent you keep getting some of these offsets in services, whether it is shelter or anything else within that world, even if it's energy related, it's going to be hard to still ... it's still going to be hard to have those conversations about how much tariffs are causing and how much they're an overall burden in causing inflation. So I don't know if we should extrapolate January. I think there were enough one-offs where it's a little bit tough to take that one month, especially given what we know about January data.

But to your point about some of these anecdotes starting to creep through, I think it is something important to watch because that's sort of in my mind, that's kind of what's been helping keep the broader labor market in this almost frozen phase. Because companies, they can pull back on hiring significantly, but if they don't initiate those mass-layoff cycles, then you don't have what we think of as a traditional recession. So we've kind of learned over the past couple of years that you could stay in this frozen state for labor and not have to go into what is thought of as a traditional recession. And we've learned over the past couple of months that you can go through a little bit of a re-acceleration in hiring. So I still think that there are downside risks, of course, if consumers kind of balk at the price increases, and if companies start to see slower revenue growth, and then that kicks in the cycle of laying people off.

But as we've mentioned a million times, this is such a unique cycle. We don't really have anything to base it off of when it comes to history. So we just sort of have to take it as the data roll in. And so far, you kind of have this double-edged sword where the jobs report for January was great. Hard to extrapolate that, though, because of January being a weird month. And the same case, sort of, with CPI. Headline CPI was great. Underlying details, not so great.

LIZ ANN: Let me ask a broader question here with regard to GDP, given that we're going to get that release soon. At its most basic level, there's the formula that goes into GDP, and it's driven by the private sector and the government sector and consumption and imports and exports and business investment, residential investment, but, at its basic level, economic growth is driven by productivity and labor force growth.

So maybe your latest thoughts, given that some of the aggregate productivity numbers that we've gotten recently are pretty healthy. But we also have the immigration constraint that has impeded growth in the labor force. So how are you thinking of GDP in those basic terms?

KEVIN: Yeah, I mean, if you ... when we get fourth-quarter GDP, and ultimately all the revisions come in, especially with the downward revision we got for payrolls last year, I mean, we only had 181,000 jobs created in 2025. And just for context, if you went back in the full history of non-farm payroll data, and you looked at just the years where we created jobs, that was the second weakest year on record. So the only other year that was worse was 2003 when we were in a jobless recovery after the tech bust. So you know, I say that because it very well could be the case that 2025 was an amazing productivity year, because as you mentioned, if we basically had minimal labor force growth, if any at all, all of that burden sort of shifts to productivity, and we probably had an amazingly, you know, productive year for productivity and probably lifted GDP, you know, somewhere in a range of 2% to 3%.

So it's not the, you know, the best way, air quote "best way" to go through a productivity boom, because you want aggregate income growth to be relatively healthy and to accelerate. But I think it's sort of just the state of play when it comes to what we face from not just aging demographics but, to your point, net migration. And I was just, you know, looking through a lot of the data from the Census Bureau and their estimates that came out for '25 and for 2026 around net migration. And they're expecting it to be down in the low 300,000 range for 2026, assuming, you know, current trends. That's essentially nothing when you look at it relative to history. And it's a pretty significant decline. If you look at the two-year change, it would be a historic decline in net migration.

So given the fact that we've ... and not just the United States, most of the developed world has become so dependent on immigrant labor to grow workforces. It just works against us in terms of potential GDP. So it's ... on the one hand, we've got that strong productivity component from everything that's happening on the business investment side, but at the same time, that's a relatively thin sort of stand to hang your hat on or to sort of rest on when it comes to just counting on that being your only growth driver. So we'll see if there are other remedies. I mean, I know other countries in the world have actually done a really good job—South Korea is one of them—at bringing their labor force participation rates up for older individuals. I'm not a fortune teller, but I think it'd be a little tough to get the 65+ crowd in the U.S. to come back into the labor force en masse.

There's a little bit of a difference in ... there's cultural differences there, so it's a little bit tough to, you know, to convince them ...

LIZ ANN: Yeah, Kathy and I are both shaking our heads. Our listeners can't see us, but we're in the plus-60 crowd.

KATHY: No way, Kevin, it's not happening. It's not happening.

KEVIN: Well fortunately, neither of you have reached that age, so, you know, we're still working ...

LIZ ANN: Yeah, nice try.

KEVIN: But no, those are some of the ... some of the things that, of course, I mean, that's far off from a policy discussion, but I think we have to be sort of real about thinking about some of the constraints that we face when it comes to a lot of this, you know, a lot of the labor-force discussion.

LIZ ANN: And as I touched on when Kathy and I were having our initial conversation, and certainly as you well know, Kevin, because you co-wrote it with me, but we have our latest AI-related missive out that published on the 17th, I think it was, and it's the main part, the first part of the title is "Cascade." So look for that on the Learn tab on Schwab.com, and it's a deep dive, again, at the three phases, the create, the catalyze, and the cascade phase, and maybe some of the touchpoints and what to keep an eye on as we continue to see this swirl.

So any takeaways, Kevin, from your perspective? I know, you know, part of what you wrote was the productivity side as it relates to AI, but anything else you wanted to pull out as a tease for that report, which we will put in the show notes?

KEVIN: Well, I think anybody who's been following it from a stock-market perspective has certainly been privy to, in many cases, some of the pain trades out there in terms of a lot of these industries facing some pretty significant disruption in a fairly short order. I mean, you look at the decline in an industry like software. I've been keeping an eye on the relative performance of that industry relative to the S&P 500. And it's essentially six years of relative gains that have been wiped out.

So thinking about, especially with the cascade phase, thinking about how the broader societal and economic benefits don't necessarily equate to cap-weighted index level benefits on the same scale. So it's almost a little bit of a give-and-take if you want the benefit from AI kind of diffusing through the economy, that doesn't necessarily mean you get the same return, so to speak, in terms of the market. So it's a little bit of having the cake and eating it too, you know, not being a thing when it comes to AI. So I think that's an important aspect to consider, but we've got more visuals about that, as you mentioned, in the report.

LIZ ANN: right, Kevin, always insightful. Thank you for joining us again. We always appreciate that.

KEVIN: Yeah, thanks for having me. Always good to be back with you guys.

KATHY: Well, Liz Ann, it's time to look ahead to next week as we always do. What are you going to be paying attention to?

LIZ ANN: Well, we get trade data. There are times in the cycle where nobody cares about trade data, but in a tariff regime, that becomes a little bit more important. So the overall trade balance as well as the import-export data. You know, the LEI is coming out, the Leading Economic Index, which doesn't say much these days. It has not worked, if you want to call it that. It has a manufacturing bias to it, which is not an error on the part of the Conference Board, which puts out the LEI, but reflection of the unique nature of this cycle where we've had manufacturing in a recession until recently. If you use the ISM manufacturing index as a proxy for maybe manufacturing having pulled itself out of a recession, but it didn't bring the overall economy down with it because the feeder into services just wasn't there, and a lot of that is vestiges of the pandemic era. So it comes out, I don't pay as much attention to it as I have in the past.

We get personal income and personal spending. It's always interesting to see which one's higher on a month-to-month basis. More often than not in the last couple of years, spending has been greater than income, but given that we're seeing a bit of a retrenchment where we saw the weak retail sales, it'd be interesting to see if we start to see that in some of those numbers. We already touched on the fact that we get the PCE, which is the Fed's preferred measure of inflation. We already said we're getting GDP. And then we're also getting lots of housing data. And we've started to see maybe some green shoots in housing. So any additional data will either corroborate that or suggest that some of the better recent data was a blip. How about you?

KATHY: I think among those obviously the ... you know, Personal Consumption Expenditures price index is going to be the big one after we had the softs, you know, Consumer Price Index, we'll be watching the PCE to see if it corroborates that or, you know, if it doesn't. PPI, Producer Price Index, we'll get that as well. And I think that's important to watch.

And when it comes to GDP, I know we're getting those numbers sooner rather than later, but I did a little quick and dirty survey going back 25 years or more. And there's never been a time when the Fed has cut rates when nominal GDP was running 5%, 6%, except in 2000 when we got the big correction in the stock market.

So I'm kind of going to be watching that in nominal terms rather than in real terms just because it'll be interesting to see if the Fed can somehow figure out what that means for them in terms of policy.

LIZ ANN: One other thing, Kathy, I wanted to mention since you talked about GDP, and I believe we should be getting it in conjunction with GDP because we typically do, but the national income and product accounts version of corporate profits. It's a much, much wider berth than what the S&P 500 represents. It's millions of companies. It's publicly traded companies, private companies. It's all the big companies that are represented by an index like the S&P, but it's lots of really tiny companies and sole proprietorships and S-corps. And the earnings growth rate for that much broader measure has been fairly anemic relative to double-digit kind of growth for the S&P 500. So we'll have to see if that trend continues when we get that release.

KATHY: OK, now that's important for the credit markets, as well. So we keep an eye on that.

LIZ ANN: All right, well, that's it for us this week. Thanks as always for listening. As a reminder, you can keep up with us in real time on social media. I'm @LizAnnSonders on X and LinkedIn. Finally, my imposter problem is starting to ease a little bit. Still be mindful of that, but it's less of a problem than it has been.

KATHY: I'm glad to hear that, Liz Ann. I know you've been plagued by that. Fortunately for me fewer people want to be bond analysts, so I get fewer imposters. I get a handful, and I always wonder like "Really? What's wrong with you?" But anyway, I'm @KathyJones on X and LinkedIn, and that's Kathy with a K.

KEVIN: And I'm @KevRGordon on both X and LinkedIn.

KATHY: And you can always read all of our written reports, including lots of charts and graphs, at schwab.com/learn.

LIZ ANN: And if you've enjoyed the show, we would be so grateful if you would leave us a review on Apple Podcasts, a rating on Spotify, or feedback wherever you listen. And please tell a friend or two or more about the show, and we will be back with a new episode next week.

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