



Why Corporate Earnings Matter for Stocks, Bonds & the Fed

COLLIN MARTIN: I'm Collin Martin

LIZ ANN SONDEERS: And I'm Liz Ann Sonders.

COLLIN: 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.

LIZ ANN: Well, hi, Collin. One of the things we chatted about last week was earnings season, which has now kicked in. And so maybe we'll start there today and talk about why it's important. It's always important for the trajectory of the equity market. That's the ultimate "duh" statement there. But maybe give me your perspective on the fixed income side of things, what earnings can mean both from a macro standpoint, but maybe what it says about the health of corporate America, maybe how that ties into ongoing concerns about strains in the credit market. So take it into the fixed income world, how you think about earnings season when it's underway.

COLLIN: Yeah, absolutely. And before I start, you know, we've been doing this a few weeks, Liz Ann, I have to say one of my favorite things is when you use the "duh" phrase. I think that's one of my favorites.

LIZ ANN: That's ... it's one of my favorite words. I will inevitably use it again on this, probably on this episode. So beware.

COLLIN: I'll see if I can incorporate it, too. It cracks me up every time.

LIZ ANN: It's a very sophisticated, a little bit technical word, but I figured if I use it enough, people might grasp its meaning.

COLLIN: Hey, we're here to lower the temperature sometimes and eliminate the jargon. So on the idea of earnings, yeah, it probably matters a lot more for you, but

of course it matters for everything macro and everything fixed income as well and what it means for the bond markets. I probably look at earnings a little bit differently than you because I have my bond market goggles on, and I care less about earnings in the here and now, and I care more about what are long-term expectations, and can businesses and companies service their debts? And this is something that I've focused on for a while.

So I look at all aspects of the bond market, but corporate bonds are one area of focus for me. And if we kind of compare reactions in the stock and the bond world, let's say a company has a bad earnings report, it might send the company's stock down pretty sharply. We probably won't see that sort of reaction with its bonds because as long as they can continue to remain current on their interest payments or refinance or repay their debts as they come due, that's what matters more.

So on the idea of earnings, we started earnings season, but I want to go back a week or so, and we kind of teased this before about corporate profits at a big macro aggregate level. I think we talked about the idea that we were looking at them last week. So embedded in the Bureau of Economic Analysis, the BEA, in their GDP report, they include corporate earnings and corporate profits. So I tend to focus there. And we got a really, really strong reading in the fourth quarter of last year.

LIZ ANN: And by the way, let me just interject. if you ever hear, if our listeners ever hear anybody refer to, like I often do, "NIPA" profits, that's National Income and Product Accounts. And that is the broader corporate profit measure that is obviously distinct and much broader, distinct from and broader than the S&P 500®. So I just wanted to throw that in. Back to you, Collin.

COLLIN: No, that's right. It's much more broad, much more comprehensive. It includes businesses of all sizes, public, private. So it's a bigger look than, say, a narrow S&P 500 focus on earnings. But if we look at those results, they were really, really strong. On a pre-tax basis, corporate profits rose in the fourth quarter to \$4.35 trillion. So it was up \$246 billion for the quarter. And if we look at the quarterly increase in percentage terms, it was about 6%.

That was the largest quarterly increase since the second quarter of 2022. So that's really good news. You know, if businesses and companies are making money, that might allow them to invest, hire people, might keep the labor market more resilient. I mean that's something that's been a concern for, I know, a lot of people. You know, will we start to see more cracks appear? And maybe this helps prevent that.

Now, fundamentals and earnings, when we look at corporate bonds, that's only one part of the puzzle because the level of borrowing costs and the availability of credit

matters, too. So that's really where I come in. And if we look at what businesses are looking at from a borrowing cost standpoint, they're up a little bit this year, but it's mainly driven by rising Treasury yields and not necessarily from a spread or the extra yields that businesses pay on top of a comparable Treasury, given the risk of lending to a business or corporation since there tends to be more risk with a business versus lending to the government, which is backed by the full faith and credit of our government and our Treasury. So yields are up a little bit, though.

And that's one part of the puzzle, too. That means it's a little bit more expensive for businesses who are issuing debt right now. And expectations matter. And we've talked a lot about the changing expected path of Fed policy over the next few months or even quarters. And if short-term rates don't fall much, that means that businesses who may have been maybe relying on lower borrowing costs down the road for new issues or to refinance, that could pose somewhat of a challenge. But overall, the picture is pretty positive. When I said before, I look at earnings differently, for the most part, they're still supportive of corporations.

But there are little areas that we're worried about. And when we think about corporate bonds, we separate them into the investment-grade corporate bond world and then the high yield. So corporations have credit ratings, just like you and I have credit scores, Liz Ann. And we're seeing some concerning trends with the lowest level of those bonds, so CCC ratings, one of the lowest rungs. So that's where if I take in earnings and borrowing costs, there's a measure that we look at to kind of identify how strong or weak a borrower is. It's called the interest coverage ratio. It's "What are my earnings relative to my interest expense?" And if we kind of dial in on that lowest rung, those CCC-rated issuers, we get data from Bloomberg, and that interest coverage ratio has been less than one for about two years now. So that means that these companies, on average, are earning less than they have to pay in interest payments. And if the trajectory of Treasury yields stays where it is, if yields kind of stay elevated or even increase, that poses more of a challenge. So it's not a big concern for us as it relates to investment-grade corporate bonds and even the higher-rated parts of the high-yield bond market should be OK, but we could see more headlines of potential defaults if we see some of those riskier companies face some challenges if their earnings stumble a little bit, and interest rates stay kind of where they are.

So Liz Ann, let me bounce it back to you. I'd love to hear ... you know, obviously earnings matter a lot for the stock market, but also I'm excited that this is, I think, the first time in a few weeks that we haven't launched right into the impact of the conflict.

LIZ ANN: Right.

COLLIN: So I want to hear, so I'm interested to hear about ...

LIZ ANN: Taking a break from the war ...

COLLIN: I'm interested to hear about earnings. But then of course I would love to hear about what is going on in the Middle East. We've seen good news, bad news, oil prices still elevated. What does all that mean?

LIZ ANN: Yeah, so, Collin, let me start narrow and then I'll get bigger picture. One of the comments you just made was about interest coverage. And that's been an important factor in what our recommendations have been. And I mean that both literally and figuratively. As you know, and I hope probably many of our listeners know, and certainly our clients know, we have in the equity side of things at Schwab been very focused on factor-based investing, which "factor" is just another word for "characteristic," versus the more monolithic sector-based investing or investing in cohorts as a, for instance, you know, the Mag 7, believing that investing in certain characteristics is the right way to approach this somewhat unique market environment, especially in the throes of what we're dealing with the war.

And because you mentioned interest coverage, that's been a fairly consistent factor of focus for us, companies that have that ability to pay interest on debt. And it's especially important when you go down the capitalization spectrum. For a while there, it didn't seem to matter to smaller-cap investors, those sort of balance-sheet issues, the profitability issues, but it is starting to matter a lot more.

And one way to illustrate that is last year within the Russell 2000, the non-profitable stocks, and 40% of the Russell 2000 are non-profitable stocks, that cohort within the Russell 2000 was up 20% last year. The profitable stocks were up only 10% last year. So double the performance of the weaker, lower-quality non-profitable stocks, many of which were actually zombie companies. So companies that aren't earning enough cashflow to even pay the interest on their debt, let alone to fund ongoing operations.

This year, it's a completely different story. On maybe two days out of date in looking at the data, but as of the end of this prior week, because I look at the data on a weekly basis, the profitable stocks were up about 8%, and the non-profitable stocks were actually down a little bit. So a big flip-flop in favor of that profitability. And I think that is something that is likely to persist. But widening the lens a little bit to S&P earnings season, which has just gotten started, it's too soon yet to put any value on things like the beat rate, the percent by which companies have beaten, just way too early in the season.

But I'll talk a little bit about what the trends in estimates have been. It's kind of an interesting backdrop, because for calendar year 2026, in January, consensus estimate was that earnings growth for the overall S&P 500 would be 15.6%. That has now jumped to 19.3%, which is a pretty remarkable jump for calendar year estimates, given what we've had going on since the end of February.

That said, the latest trends, call it in the past month or so, have been to the negative. There has been a deterioration in near-term adjustments to earnings. There's an index that I track, particularly during earnings season, which is the Citi U.S. Earnings Revisions Index. It's kind of a sister index to their much more widely followed Economic Surprise Index in the case of the latter. They're just looking at economic data as it comes in, what's surprising on the upside relative to estimates, what's surprising on the downside, and they track that. They do the same thing for earnings estimates, and it tends to somewhat obviously come into focus as an indicator as you're approaching earnings season.

When the index is rising and above the zero line, it means there's an improving number of positive revisions and that being above the zero line means there's net more positive revisions than negative revisions. Well, that line has been heading down and is actually now in negative territory. So a deteriorating trend and now more net-negative revisions than positive revisions, with those revisions, though, concentrated in the first quarter. So we're finally seeing analysts say, "All right, we need to adjust some numbers here. We're probably too high."

In fact, the only sector for first quarter '26 that has seen an increase in estimates has been the tech sector. And that has largely been a function of a small handful of stocks, in particular Micron and Nvidia really account for a lot of that upgrade. That leaves 10 other sectors, all of which are no better than flat and most of which are down in terms of estimates for the first quarter. I think there's going to be more adjustment when we actually start hearing from companies. And it may necessitate some adjustment to second quarter numbers too, especially if throughout the course of earnings season, we don't have a resolution to the war. That's where we sit right now.

You don't know what this outcome is going to be. I don't know what the outcome is going to be. You know, you've got now a full blockade on the strait, but you're ... it's a blockade of a strait that was already effectively closed so double blockade, I guess. And as we've talked about on the show, and I think everybody is well aware of now, so we do not need to go into minute detail, it's a really important choke point. It's not just a choke point for oil, but natural gas and fertilizer and helium, which goes into chip production. So this is more than just a crude oil story, and it does have

filters, not just into headline levels of inflation, but eventually it would filter into core levels of inflation. That obviously impacts what the Fed can and can't do.

That said, clearly, the equity market is betting on some sort of resolution. We've had now a full round trip. We've recovered losses since the onset of the war at the end of February. It was tied for the shortest number of trading days, and it was 11, that it took for an 85% retracement of the move, which is often what technical analysts focus on. Pretty good win rate, looking a year out after periods like that, with about four exceptions going back to 1950. So it's not a perfect track record that if you have a retracement this powerful in this short a period of time, it's no holds barred, straight ahead, limited risk on the downside.

So I think we're still at the mercy of oil prices and narrative changes and postings, but so far, so good. And I think earnings is probably a big part of that because that is the most important fundamental support you can point to as it relates to equities.

You know, speaking of the Fed, what is your latest thinking there? Where do we sit with the Kevin Warsh nomination? So give us a lay of the land from a Fed perspective.

COLLIN: So just from a high level, what's our view of the Fed over the next few meetings? We don't expect the Fed to do anything. And you mentioned this before. No one knows what's ultimately going to happen. And so we try our best to look through everything that's going on and provide more of a long-term outlook. So we're not precise with our Fed outlook. We don't know when and how much the Fed will cut or hike down the road. But what we are confident in is that the Fed will likely hold steady for the next several meetings. Several might be a little bit open-ended, but I mean, I think that will probably take us into the fall at least. And when we look through the end of the year, maybe we'll see one cut. I wouldn't expect any more. Maybe we see no cuts. So that's kind of our outlook right there, mainly due to inflation. Inflation was high coming into the conflict. We've already seen it increase with that CPI data, and it'll probably continue to rise a little bit the longer this goes on. And Fed officials are very cognizant of that.

And we've gotten a handful of comments from either governors or district bank presidents about their outlook. We got an interview from Beth Hammack, and she said the Fed will probably be on hold for a good while. I like that term. It's open-ended like ours. But that's kind of how we're looking at it. So we need to get more clarity on what the war looks like, what oil prices are going to do. So instead of trying to be precise, we just think they'll be on hold for the time being.

LIZ ANN: Collin, what do you think would have to happen for the Fed to consider hiking rates? Because that got, what, several weeks ago, I think, a hike got priced into the fed fund's futures market when we were earlier in the throes of this war. But what do you think? How dire would the inflation data have to get, alongside probably what would need to be a continued resilience in the labor market to justify a hike, but how do you think about what would trigger that?

COLLIN: Yeah, a lot of moving parts. So one, the magnitude of inflation, we need to see it move up more than we've seen so far, but also we need to see, I think, core inflation readings move up. Because we know that the Fed can't really do much to bring the price of oil down. It can't open up the strait. So it will probably look through the headline number a little bit. I think inflation expectations will matter a lot. Because if we see inflation expectations get unanchored, then the Fed might get concerned because then that can change our behaviors as consumers. If we expect inflation to go up, we might start buying now and then it becomes a self-fulfilling prophecy. So I think those are the key things.

You mentioned the labor market. If the labor market weakens, that makes the Fed's job a bit more difficult, you could say. If it holds up, maybe you'd need to see the labor market hold up and inflation expectations rise to really begin to price in a hike. We're not there. Never say never, of course, but it's definitely not our base case. And we'd need to see kind of those factors filter through before we started talking about what rate hikes mean for our clients and what it means for the overall bond market.

And then the final wrinkle is Kevin Warsh as a potential new Fed chair. But the short answer is it doesn't matter much for us. That's because if Warsh comes in, he's one member of a 19-person committee, of which 12 are voting members. So he only gets one vote. Also, he's not replacing Jay Powell. I think that's very important to put out there. Jay Powell's term as chair ends in May. His term as governor ends in 2028. He may choose to stay on. We don't know, but what we do know is that if Warsh does get confirmed to come in as a governor and be the new chair, he will be replacing Stephen Miran, not Jay Powell. And Stephen Miran is one of the most dovish committee members out there right now, Fed governors. He's been dissenting and, you know ...

LIZ ANN: I would say *the* most.

COLLIN: We always have to hedge here, Liz Ann. We got to hedge. But OK, I think we can say he's the most, he's dissented the most. His projections are for rates well below his other participants, as well as most market expectations. So we'll just be replacing one dove with another potential dove, so our outlook, it hadn't changed

before everything that's going on with Iran began, and it certainly doesn't change now because inflation obviously is proving to be a little bit stickier.

I want to toss back to you because we're hearing more about tariffs. And we kind of forgot about 'em for a little bit, and there's been some headlines. I think Treasury secretary Bessent mentioned we can expect to see new tariffs. He mentioned a specific, I think, month in the summer. What are your thoughts on that? Because there's actually, I'd say, there's two things that we need to look at. One is potential refunds. What does that mean for our fiscal situation? And two, if we get tariffs in place at levels that we saw before, does that change your outlook at all?

LIZ ANN: Well, you know the mechanics, by the way, of tariff refunds is expected to be somewhat nightmarish. And then the secondary question is, "OK, if there are going to be refunds, do the companies getting the refunds, which are U.S. companies that paid the tariffs, what does that mean for their pricing strategy?"

Are they going to essentially pass on that refund cost to consumers by lowering prices? And there's not a lot of evidence that that is something being planned right now. So it may be that companies paid for the tariffs, passed on a lot of those costs to consumers, open question as to whether consumers will ultimately be the beneficiaries of any kind of refund strategy, you know, the answers to which we don't know.

In the meantime, tariffs have had an impact on inflation. If you look at aggregate data, you can massage it a bit. You can look at, you know, core Consumer Price Index that has a big weight in owner's equivalent rent, which is not impacted by tariffs. There has been deceleration there, and that's accrued to the benefit of core CPIs. A lot of people are saying, "See? No impact of tariffs." But you can't look at inflation in the aggregate. You've actually got to go to where tariffs have had the impact.

And in the interest of putting something out there that is an external source for this and not just me putting up a Bloomberg chart, which some people will say, "Oh you're just picking and choosing and manipulating the data." There's a Cato Institute chart that's been making the rounds, and it's kind of gone viral. I put it on my X feed, I think, Monday. And it just looks at the domestic price index and the import price index and shows where we were since the beginning of 2024. Downward trend extends that trend as if no tariffs had kicked in and what that trend would have looked like had that trend stayed in place and then puts in two important dates to see what happened since those dates.

The first was actually pre-"liberation day." So it was early March of last year when the IEEPA, International Economic Emergency Powers Act, tariffs were put in place

on goods coming in from Mexico and Canada. And then subsequent to that, less than a month later, the liberation day, so-called reciprocal tariffs. And it's really clear what you see. So take a look at that chart. You really did inflect higher at that point and have continued in general to trend higher. So to me, you do find it in the inflation numbers. You just have to look at the components of inflation that are most directly impacted by tariffs.

COLLIN: Can I ask ... I want to ask a follow-up here, and it's kind of ties into a lot of things we've been talking about and just as it relates to our broad outlook, and I think the big question right now is, when we look at what's going on with Iran and we know the price of oil has risen, and we think that there should be negative consequences at some point, right?

How much do you think the idea that tariffs ... well, they're down a little bit now. There's still some uncertainty. And we know that it's expected to be a pretty big year with tax refunds, and there's a lot of discussion about the tax refunds offsetting some of the price in oil. So you know, I talked about my Fed outlook and what is going on in the Middle East and how that flows through. What are your thoughts? What do you think we'll need to see before we might start to see some cracks in consumer spending?

LIZ ANN: Well, I think you are, but it's more down the income spectrum. And I think that has relevance to things like the One Big Beautiful Bill and to whom it's accrued as a benefit. And the interesting thing, yes, tax refund season is going to be a strong one, stronger than last year, though not as strong as what was expected even a few months ago. So it's a relative to last year, relative to your standard year, great, relative to what maybe overly heightened expectations were, a little bit less great.

In addition, as part of that bill, you also had sort of diminished transfer payments, which accrued to the disadvantage of lower income people. So they're not benefiting from some of the sort of lower tax part of the bill, but they're hurt by the lower transfer payments, in an environment where they're getting hit by higher energy costs because it's a larger share of their consumption basket relative to the income that comes in.

So this is yet again, another, not just reinforcement, but maybe something that exacerbates the K-shaped nature of this. So yes, we have absolutely seen cracks. They tend to be down the income spectrum, down into the sort of subprime in terms of things like delinquencies and defaults, key to watch is if that starts to creep up. So far, it's somewhat contained, but it's something to keep an eye on.

COLLIN: All right, Liz Ann, well let's look ahead to next week, so what's on your radar?

LIZ ANN: Well, you know, as we're having this, we did get Producer Price Index, which was much more benign than what we saw with Consumer Price Index. So a little bit of an alleviation of some of those concerns. We'll get additional information on import and export prices. I just put on my X feed the basics there, but some of the details might be of note.

We, you know, claims, I think that that's the key leading indicator, unemployment claims for the labor market. So every week they ought to be in focus. We get industrial production and capacity utilization. Industrial production is a key component of the Coincident Economic Index, one of the four metrics used to declare and time recessions. Very little risk of a broad economic recession at this point, but ...

And then maybe the more important one would be retail sales, to your point, Collin, about the health of the consumer. So that comes next week. I'd keep a close eye on that. And then we get the S&P Global version of the Purchasing Managers' Index. So it's kind of a parallel to what ISM does with their services and manufacturing index, S&P Global's version. So I'll keep an eye on that as well. How about you?

COLLIN: Well, no surprise, a lot of the same ones. But for me, retail sales, I think, will be really important. There's always a caveat there because those are nominal. So price increases can reflect some of the increase if we see it. But I think that'll be really important. My big question for the economy and for our outlook is, "Can consumption remain strong?" So I'm going to be looking at those retail sales for March, knowing that the war had begun. So there had been, you know, that had at least at a headline basis and maybe from an uncertainty basis, that was out there. So it's going to be curious to see if that flowed through.

We get pending home sales. I think that's interesting because we've seen a rise in mortgage rates and, you know, that's ... I'm curious to see how that flowed through. We saw a nice, you know, decline in average mortgage rates over the past few years, but now it's close to 6.5%. So we'll see how that is impacting the housing market because that can have big impacts. I still remember it vividly. I became a first-time home buyer about six years ago, and I was not prepared for how much money I was going to spend in those first few months. That just spurs so much activity. So I'm focusing on all the housing data we're getting.

The S&P PMIs, like you mentioned, because we got slightly lower than expected ISM numbers, the Institute for Supply Management, PMIs. So we'll see how the S&P, the

Standard & Poor's ones, look. And then we get the final release of the University of Michigan surveys. And that will be important because the preliminary ones showed a really sharp drop in sentiment and expectations. I believe the sentiment fell to a record low. So we'll see how that looks.

And then in terms of what I'm looking for the Fed, not much, because on Saturday, April 18, Fed officials go into their quiet period where they can't comment on policy or their expectations. So the last we'll hear from Fed officials after Friday the 17 will be at the April 29 Federal Open Market Committee meeting.

Well, thank you as always for listening. As a reminder, you can always keep up with us in real time on social media. I am @CollinMartinCS on X and LinkedIn. You can follow me there @CollinMartinCS, and that's Collin with two L's, not one, and the CS is for Charles Schwab.

LIZ ANN: And I'm @LizAnnSonders on X and LinkedIn. Make sure you're following the actual me. Still have lots of imposters, and you can always read all of our written reports, they typically have lots of charts and graphs, and those can be found at schwab.com/learn. And I also want to put in a plug for all of Schwab's podcasts. We have shows on behavioral finance, politics, financial planning, even golf. And you can find them all at schwab.com/podcasts.

And one other plug I wanted to make: We put out a report last week, on the whole idea of gambling versus investing. And that is such an important subject for Schwab as a company, a message that we want to continue to get out there, that there's too much conflating of gambling versus investing. So the report is called "Gambler's Blues." And I will link to the written report in the show notes and also to the video version, a condensed video version, that is called "Owning Versus Hoping." So have a look at both of those, whether you're somebody that likes to read or somebody that likes to watch and listen, we give you the choice.

COLLIN: That's a great plug. It was a really good article, Liz Ann. I think it's important and very timely right now. And if you've enjoyed the show, please consider leaving us a review on Apple Podcasts, a rating on Spotify, or feedback wherever you listen. And please tell a friend or more about the show. And we will be back with a new episode next week.