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IPOs in Focus as the Fed Holds the Line

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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.

COLLIN: Well, hi, Liz Ann. We're back again. And I'm really excited about the topic I want to throw your way because it's all I'm hearing about these days, initial public offerings, IPOs. And I feel like I can't go a day without seeing a new headline about the numbers involved here, how big they are. They're truly, truly staggering numbers.

Over the years, you've seen a lot of companies go public. This is nothing new. There are cycles where you get kind of these big names. So I kind of want to just keep it open-ended. And what should investors be thinking about this? How should they price things out? And I think there's an idea that maybe some investors have FOMO, or fear of missing out, when you get these big IPOs. So what are some big-level thoughts you have about what's to come over the next few weeks?

LIZ ANN: Yeah, well, there's certainly, Collin, a lot of hype and enthusiasm associated with them. And we're limited to how specific because we don't cover the companies. But in the aggregate, there's a lot of attention on the sort of valuation size, the total market capitalization size expected with some of these IPOs. And the big three that have been most discussed, most estimates put them collectively at about \$4 trillion. But that is somewhat irrelevant for mechanics around the indexes, because the questions I often get is what does it mean for an index like the S&P 500®? Because what matters is the float, how much of the shares that are coming to market. So float-adjusted market cap collectively is kind of a fraction of what the total valuation of the companies is.

Historically, mega-cap technology-oriented IPOs, especially if you look at the ... lots of ... cluster of them in the late 1990s, typically offer between 10% and 20% of total shares to the public. At this stage, given what we know now, the companies are talking about 4% to 9%. So that is a smaller float. That's something to think about if you see headlines that are not float adjusted.

What's also been garnering attention, that I think is a valid reason, is that there's going to be, or apparently going to be, some restrictions lifted in terms of both the timeframe that these stocks could make their way into an index like the S&P 500 or the Nasdaq, and in the case of S&P 500, which has a profitability filter, whether S&P might put that aside in the interest of bringing them into the index. So that's something just to be mindful of because one of the reasons why the S&P is generally considered a higher-quality index is because of that profitability.

COLLIN: Hey, Liz Ann, quick question on that. The numbers, like you mentioned, how to think about them. So if I'm hearing you right, because I'm seeing these numbers too, and I have my own questions. When we see that trillions being thrown out there, that doesn't represent how much is actually being issued at the time, because you said it's small portions and smaller than what we've historically seen for a lot of the tech ones.

LIZ ANN: It's probably less than 1% of the S&P 500 index in the aggregate. And you'll sometimes see numbers, you know, four or five times larger than that. But that's usually because they're not adjusting for that float.

COLLIN: OK, that makes sense.

LIZ ANN: But that's, and all of this is based on what we know now, and we're not investment bankers, and we're not analysts so ...

The other issue that is a little bit more down the road is that there is more of a, I guess you'd think of it as a structural risk, because there will ultimately be kind of a phased-in expansion of the company's float, typically over six to 18 months following the initial public offering, particularly if the lockup expirations cluster, that's another thing.

But that's down the road. That's in the aftermath of the IPO. But in an environment where there's very much a gambling mentality, we've talked about this a ton, and the stock market can resemble a casino at times. And we know that FOMO, fear of missing out, has been a big driver of some of these parabolic moves in stocks. I guess the overarching message to investors is make sure you understand how this fits in a portfolio and it is not just the chasing of the hype. But that's standard advice we would give in any kind of market environment where there's a lot of speculation happening.

So what's going on in your world these days? You know, we're in a week here taping this where we've got a jobs report at the end of the week. So we won't have color on that in this episode, but seems to be a little bit of calm that has crept back into the bond market. What do you think has led to that calm, and how are you thinking about the yield backdrop as we head into a jobs report and of course the first Fed meeting under new chair Kevin Warsh?

COLLIN: Yeah, I would say it is a relative calm. I think we've seen a drop in the 10-year treasury yield from its highs of a couple of weeks ago. I think that has generally tracked the price of and an optimism of a potential de-escalation, but now we're seeing oil prices up a little bit. It's been trading in a range. But calm is good.

I'd say I'm always excited by the bond market. I can confidently say it's probably less exciting than all these IPOs you're talking about. But we're in an interesting period right now. You mentioned Warsh coming in as the new Federal Reserve chair, and there's just so much dialogue right now around the Fed's next move. And for better or for worse, we harp on that. We know that a lot of listeners are paying attention. We see it all over the financial media. But we're taking a more long-term view. We think the Fed is probably not going to do anything for the next several meetings. We think they'll be on hold through the end of the year.

But we do acknowledge that the balance of risks has shifted given the increase in inflation we've seen. But I don't think that a rate hike is necessarily more likely than a cut right now. I do see it as two-sided risks. And we did get some commentary from Fed officials just recently about the idea that maybe there isn't such an urgency to raise rates right now. So I do think they're going to take a wait-and-see approach.

Whether they hike, cut, or hold steady over the next six months, at the end of the day, for lot of investors, that might not matter too much. If we're talking about one hike at some point down the road, or even one cut, that might mean a move up or down in short-term interest rates, but I'm not sure if it's necessarily the start of a big trend. I think that's really important.

I always like to involve stories about friends or family. My dad often will say, "Hey, what do you expect the Fed to do next week?" And I'll toss it back to him and say, "Well, how is this going to impact you?" And that's kind of how I want to frame it. For better or for worse, again, there's no shortage of topics there on the Fed. I do think Warsh is going to have potentially a challenging situation knowing that he probably had a more dovish tilt coming in, that he probably would have been advocating for lower rates. I'm not sure he can necessarily do that right now, given where inflation's been, given that it's expected to increase. I think, I would think he'd risk credibility with his fellow policymakers if he were to try to advocate for

lower rates. So I don't think he'll do that either publicly or privately, just given what we're seeing.

LIZ ANN: Not to mention the potential for long end to sort of riot a bit on that, no?

COLLIN: A little bit, but I've seen some headlines. I don't necessarily agree with it, but there's an idea that maybe they hike sooner rather than later to keep the long end more intact and not risk having long-term yields rise. Because this is where things get a little funky, the dynamics of the bond market, where if it seems like the Fed is too slow to act, and they hold rates steady or too low, whether that's right or wrong, time will tell. But if they hold them here when inflation's rising, maybe you see long-term yields rise to reflect that inflation risk down the road.

So I've seen some ideas where maybe they hike soon to make sure we as investors and the market see that, no, no, we are here to finish the job. I'm not there yet though, Liz Ann. I think they're going to hold steady. The last cut they did was in December of last year. This would be a pretty quick pivot to hikes, but you never know. If they want to prove that they're there to fight inflation.

But it'll be a very interesting discussion, especially at the next meeting in a few weeks with Warsh coming in as the new chair. And I look forward to not just the decision, but his first press conference. But the idea of kind of, I wouldn't call it a conundrum, but the idea of how they're approaching monetary policy right now and looking at the incoming economic data, I'd say generally speaking, it's been pretty good.

This week is a very small sample size, but we've gotten better than expected ISM numbers. We saw a JOLTS report that was relatively strong, Job Openings and Labor Turnover Survey. And then as you said, we will get the jobs report on Friday, which probably that matters a little bit more than JOLTS, I'd say. But we were talking before this about the ISM, the Institute for Supply Management, and other PMI, Purchasing Managers' Index, and how maybe they're diverging a little bit. So can you expand on that?

LIZ ANN: Sure, and it is an interesting divergence happening. So you saw the better-than-expected ISM services index, worse than expected and a little bit of a move down in the S&P Global version. And I started to get a lot of questions on my social media feeds about why there is a difference between those two.

Ostensibly, they're asking similar questions of members and what, if anything, it signals when there is a divergence between the two. And anybody interested in more detail on this, I did post a longer note on the differences between the two on my X feed. But the bottom line is ISM is the more widely followed version of the

PMIs. They survey between 300 and 400 purchasing and supply executives, and they're all their member companies, ISM member companies.

So it tends to be a smaller subset of companies that they survey, and they are much larger in the aggregate. Whereas S&P Global—and by the way, it used to be IHS Markit—now it's run by S&P Global. They survey about twice as many companies, and they use a more stratified sample. So they design it to more closely mirror the composition of the economy by sector by size. So arguably it's a little broader perspective. And they also, as the name S&P Global suggests, they also survey companies in 40 different countries, whereas ISM is limited to the U.S. It is the case that at times when you see a divergence, it doesn't always work this way, but S&P Global tends to be the better early signal if there's a change, even though ISM is still more of the market moving number and has more history also. The bottom line is pay attention to both.

COLLIN: So on the idea of a divergence, we're calling it, how do the levels look? Then you always say, what matters more, direction, change, level? Is the level still OK?

LIZ ANN: Yeah, the level is still OK. So the S&P Global's version is down to a little, I think, 50.7. That is still above 50, and 50 is considered the demarcation point between expansion and contraction, whereas ISM's version jumped up, and that's at 54.5. But they are both still in expansion.

So in the case of both of these PMIs, it's both level and direction that matters. Oftentimes we say direction matters much more than level, but given the proximity to 50, psychologically at least, that's an important level marker.

COLLIN: Yeah, that's a good point. Direction matters, level matters, but as you said, 50 is that line of demarcation. So it seems like it's still in that expansionary territory, but if it's declining, it's getting close.

LIZ ANN: What else is on your radar as we think out over the next ... obviously, we both have the labor report. We'll be digesting all of that and posting about that the same day that this podcast episode drops. But looking out over the course of the next week, what's on your radar?

COLLIN: Over the next week, we get more inflation data. And I feel like we talk about inflation a lot, but obviously that flows into the Federal Reserve outlook. So next week, we get both CPI, or Consumer Price Index, and PPI data, Producer Price Index, both expected to rise on a year-over-year basis. No surprise there.

Well, maybe a slight moderation in the monthly numbers because we've seen them move up in the price of oil, and so maybe the rate of change might come down. But if we look at expectations for core CPI on a year-over-year basis, it fluctuates as

analysts put in their forecasts, but it's close to 3%. So moving in the wrong direction. And then PPI is important because that shows how much of that are the producers seeing that could then get passed along to consumers. So very important there.

We get existing home sales next week, and housing market's always important. It was, feel like we talked about it a lot more over the previous years, but with the 10-year Treasury yield rising and mortgage rates rising, and knowing that we're kind of in or near the peak home buying and selling season, interesting to see what home sales look like.

And then I love a good, wonky bond nerd thing that I look forward to. Next week we get the Fed's Z1 Financial Accounts of the United States report, which is a massive behemoth of a data dump, if I can describe it that way. There's just, it's a lot of tables and very little text, but it gives us really the state of U.S. households and businesses. And there's a lot of good nuggets in there. We get household net worth data in there, but then one thing I always focus on is the corporate side of the equation, because we can kind of see what their balance sheets look like, liquid assets on hand, liabilities, see what that ratio looks like. And lately, the health of the corporate market has been pretty strong. Corporate fundamentals have been pretty strong. We'll see if that trend is continuing. So what about you? What's on your radar?

LIZ ANN: Well, we get two versions of inflation expectations next week. We get the Fed's version, then we get University of Michigan. University of Michigan's inflation expectations comes out in conjunction with their consumer sentiment reading. And that continues to be interesting because you've got consumer sentiment that is at record lows in the many-decade history of that data. Obviously, in stark contrast to what the economy is actually doing and certainly in stark contrast to what the stock market is doing, but I'll pay attention to those. You mentioned Consumer Price Index, Producer Price Index, get some trade data out, especially with tariffs back in the news to some degree.

And then lastly, the NFIB, the National Federation of Independent Business. That's a monthly survey that is done. It covers a lot of small businesses, and there's an overall index, a headline index, but then there's a lot of subcomponents, including questions around what's your single biggest problem. And you often see either inflation or quality of labor sitting at the top. Sometimes it's concerned about taxes. And then there's always a lot of verbatim comments within a report like that. And that's a nice way to get in-the-moment color, not just on what's happening with the mega companies in the economy, but the important smaller-business component. So that's what's on my radar.

COLLIN: Well, as always, thank you for listening. As a reminder, you can always keep up with us in real time on social media. I'm @CollinMartinCS on both X and LinkedIn. And that's Collin with two L's, and the CS is for Charles Schwab.

LIZ ANN: And I'm @LizAnnSonders on X and LinkedIn. Make sure you are following the real me because there's a lot of nonsense out there that's claiming to be me. And also check out our written reports. In fact, mine and Kevin Gordon's outlook, big mid-year outlook on the U.S. economy and market, just published. So take a look at that. I posted on my X feed. That'll be on [schwab.com/learn](https://www.schwab.com/learn). That's the place where all of our written reports are.

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