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Welcome to the Next Temperamental Era

LIZ ANN SONDERERS: I'm Liz Ann Sonders.

COLLIN MARTIN: And I'm Collin Martin

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. Good to see you again after we took a week off last week to celebrate the July Fourth holiday. There's plenty to talk about in the investment world with the economy, but I think it'd be good to start with the World Cup.

Unfortunately for me, my main team I'm rooting for, the USA, no longer in it, but I thought we could talk about Norway. I mean, that's been a big story for a lot of people. I mean, I'm not a big ... I'm a once-every-four-years soccer fan. And I've been really into this tournament, and I've been really following Norway, but I know you're a big fan.

LIZ ANN: Oh, yeah. So I'm 100% Norwegian. In fact, a lot of people don't know that Sonders is a made-up name. So my dad changed his last name when he was 26 years old, which was 70 years ago. He just turned 96. He's still with us. He was a first-generation American, as was my mom. I'm 100% Norwegian. And that was a time where they wanted to have, you know, American-sounding names. So my real last name is Sodefjed, with the "fj" combo like fjord. And my dad grew up in Brooklyn without anybody being able to pronounce it or spell it. And he just went with Sonders. So I'm very proud of the team and Erling Haaland, who's just so fabulous to watch. And I did, Collin, bite the bullet. I will have to, I don't know, mortgage my house, but I'm going to the game against England on Saturday in Miami. So I will be decked out. I'm getting my rowing muscles in gear, and I'm hoping for a win.

COLLIN: Well that's great. I'll be looking for you. I'm picturing a big sea of red, so I think it might be hard to find you if I'm ... when I'm watching it inside, I'm sure, in a cool air-conditioned living room. But have fun.

LIZ ANN: Thank you. Yes. Thank you. COLLIN: I was rooting for them anyway, but now I have even more of a reason to root for Norway.

So we do have plenty to talk about, lots going on, especially knowing that we took off last week. So let's kick it off with an article that you and our colleague Kevin Gordon just published. It's available on Schwab.com, where all of our articles are published. And the focus of that article was on the end of the so-called Great Moderation Era. I'm using air quotes for "Great Moderation." You can see them, Liz Ann, no one else can, but the Great Moderation Era and what sort of era we're in now. If it was the end of that, what are we in now? So can you give us an overview of what that's all about?

LIZ ANN: Sure, and this has been a theme in a lot of what we've written and spoken about over the years, but the last formal report we put out on the subject was three years ago, so I felt it was time for an update. And the Great Moderation Era, I think the label was initially given to the period by Ben Bernanke, former Fed chair, and it really represents different starting points depending on what metric you're looking at, but generally the period from the mid-1990s up until about 2022, so the early part of the pandemic. And it was an era that we defined as everything kind of gelled, G.E.L., because it was about goods, energy, and labor. We had abundant access globally to cheap goods and relatively cheap labor and energy, courtesy of the shale and fracking boom in the U.S.

It was a period of massive globalization, China joining the World Trade Organization in 2001, and that really fed what became a generally a disinflationary backdrop for that 20 to 23 years or so, again, depending on the start point, and much less inflation volatility, not just lower inflation, but less inflation volatility, less economic volatility. We had longer expansions and fewer recessions. Now, the expansions were not terribly robust, but you had smoother cycles. And I think probably the most important sort of comparison of that time was between bond yields and stock prices. Because during most of that period, with the exception of 2008, bond yields and stock prices moved in the same direction. And that's because, as you well know, Collin, bond yields, particularly the 10-year yield, which is most important to the equity market, tended to move based on what economic growth was doing, less so based on what inflation was doing. So higher yields because of higher growth without an overt risk of inflation, that's sort of nirvana for equities, and vice versa when yields were moving down.

But we put it in contrast to the 30-year period prior to the Great Moderation, the period from the mid-'60s to the mid-1990s. And we decided to label it the "Temperamental Era." And it was a 30-year era of much more inflation volatility, big spikes obviously, particularly the two big ones we saw in the 70s, that is what ushered Paul Volcker in as, at that time, the new chair of the Fed and had to significantly hike interest rates, basically bring on what were back-to-back recessions in the early '80s in order to tame inflation.

It was a period of more geopolitical instability. And then in terms of the relationship between bond yields and stock prices, it was the complete opposite of what occurred during the Great Moderation. Almost the entirety of that 30-year period, bond yields and stock prices moved in the opposite direction because bond yields, in that era, generally were keying more off what was going on in inflation, less so about growth. So any big move up in bond yields was typically because inflation had gotten out of hand again, and the equity market did not perform well, and again, vice versa, when yields were moving down.

So we do believe we're definitively out of the Great Moderation Era, not that we've seen an end to the globalization wave, but clearly, we're more in an environment of some supply chain diversification and friend-shoring and nearshoring. So a move away from that massive wave of globalization. Goods and energy and labor are not as abundant and cheap as they were during the Great Moderation Era. So we anticipate a period of more economic volatility, more inflation volatility, more volatility in terms of expectations around Federal Reserve policy. And already, if we look at a shorter term, call it rolling one-month correlation between bond yields and stock prices, that's moved back very firmly into negative territory. TBD as to whether that is long lasting, but one of the markers that we're keeping an eye on to see whether what we're exiting or what we've exited from the Great Moderation looks like something akin to the Temperamental Era or maybe a new version of the Temperamental Era. So what are your thoughts on that.

COLLIN: I agree, especially on the inflation front, where, you know, this isn't the end of globalization in my view, but we've seen a shift where, you know, not just the U.S., countries are focusing on where their supply chains are going. We're seeing a lot of shocks. If we just look at the past six years, we obviously had the pandemic shock, then we had an oil shock back in 2022 with Russia and Ukraine, another one right now.

We're seeing these shocks, and I would expect that to continue. So I'm in agreement that with this shift kind of structurally, at least for, you know, for the time being, and that's something that we're looking at in terms of, you know, what that means for

Treasury yields and inflation uncertainty. Even though inflation's come down a little bit, does the uncertainty aspect and volatility, does that keep yields elevated?

Quick question for you, though, because if we think about, you know, there's no shortage of charts that go around when we talk about the Great Moderation and how things have changed over the years. And one thing that stands out when we go back to, you know, the previous 30 years or, you know, 60 years ago and that 30-year period, in addition to the inflation volatility, we had more, a lot more, recessions. And then in the recent history, that hasn't been the case. And even if we look at very recent history, right, the past six years, we had by definition a recession that was, I think, the shortest on record.

And now here we are in an economy that continues to be resilient. The recession that a lot of people expected a few years ago, including, you know, me to a degree, right? We saw the risks rising. We never said, "Hey, it's actually here," but we said, "Hey, things are happening that could make it more likely." As we shift into this new era, do you think we'll start to see more frequent recessions or just more overall economic volatility?

LIZ ANN: I think we're going to, and don't drop the mic after the first part of what I say, I think we're going to see more frequent recessions, but, and it's an important but, of the rolling variety, which is akin to what we've experienced in the aftermath of that two-month recession that accompanied the start of the pandemic. So we've been in this rolling expansion, rolling recession kind of backdrop where we haven't had a big aggregate surge in the economy and then a big aggregate contraction in the economy, which in a more traditional cycle that is linear in nature, you go from a recession, you go recovery phase, expansion phase, then late cycle, then recession. It largely happens in the aggregate, particularly if what brings on the recovery out of a recession is massively easier monetary policy and, in many cases, fiscal policy, and that recruits to the benefit of the entire economy, and then you go into an aggregate expansion, and then you go into late cycle, and then maybe the Fed has to start to tighten. That impacts the financial system and markets first, and then it feeds its way into manufacturing and then ultimately takes services down, and that's your linear cycle.

But since the pandemic, we've had the roll through. So you had manufacturing and the goods side of the economy surge in the early part of the pandemic when services were in recession because services were shut down globally.

Then we, you know ... vaccines were created. We came out of the compression stage. Manufacturing actually rolled over, and services then boomed. Manufacturing ultimately went into its own recession and arguably only came out about six months

ago. Now we actually are starting to see the services side of the economy tick down a bit. So we have some convergence with manufacturing coming out of recession. We're seeing that within the tech space and where there are, you know, many recessions and many recoveries, depending on what regime is sort of on fire from an AI perspective. And I think that kind of backdrop is likely to continue.

So there, I think, we probably don't see the Temperamental Era rhyme with what we're expecting right now. I think we could continue to see a roll through, save for a major credit crunch or the Fed needing to really jack up interest rates to combat inflation. Then I think the risk of an aggregate recession increases, but for now I think the rolling-type cycle is maybe a feature of this next structural period.

COLLIN: You know, going back to Treasuries though, so I kind of hinted at this before, and we're seeing a lot of volatility in the oil markets, of course. Although we're recording this on Wednesday morning, oil prices are now up a little bit, given, you know, those potential for a re-escalation, but what we've seen over the past few weeks has been pretty interesting, where if we look at oil, the price of oil is still pretty close to where it was before the conflict began. Again, it's up a little bit today, but close to where it was before the start.

We haven't seen Treasury yields come down by the same amount. In fact, the opposite's happened where Treasury yields are still very elevated. So if we go back to the end of February before the initial attacks, the two-year Treasury yield is up more than 80 basis points, or 0.8%. The 10-year's up more than 60 basis points, and a lot of that has to do with kind of the hawkish pivot by the Fed and expectations for maybe it's more likely we see a hike down the road.

And it's interesting because if we go back, again to the beginning of the conflict, you saw the 10-year Treasury kind of moving up and down, at least directionally with the price of oil. And then on when it came down, that didn't really happen too much.

LIZ ANN: Same with the two-year yield, right? I mean, that has now disconnected from day-to-day moves in oil prices, no?

COLLIN: That right. Yeah, the two-year yield is elevated right now, close to 4.2%. Markets are, you know, still leaning towards a hike by the end of the year, not necessarily our base case, but a lot of it comes down to the inflation outlook. And I think it's important to take a step back and look at the big inflationary picture because even though the drop in oil prices is good from a headline basis, but core inflation, when you exclude volatile food and energy prices, is still elevated.

Even that started to tick up with the increase in oil prices. And core inflation readings, whether it was the Consumer Price Index or Personal Consumption Expenditures, they've been above the Fed's 2% target for, you know, five plus years now, by any number of measures that we look at. So it's not like the drop in oil and potential all-clear sign on headline inflation. I don't think that's the case, clearly with oil prices rising. We still have underlying inflation and an inflationary pulse. And I think that's what's keeping Treasury yields elevated as well, in addition to a number of concerns. Just the overall resilience of the economy right now. The growth, maybe it's slowed a little bit recently, but it's still doing OK.

The consumer still appears strong, and in an environment like that, you should see a positively sloped yield curve, and you should see yields elevated. So I think that's going to be the trend right now. If we start to see oil prices continue to rise, maybe that relationship picks up again. Maybe, maybe that's something that's pulling, you know ... an upward pull on Treasury yields, but not as much of a downward pull. So that's something that I'll be focusing on.

LIZ ANN: Hey, Collin, you mentioned the PCE, which is the Personal Consumption Expenditures Price Index, and that's ostensibly the Fed's preferred measure. There is talk about potential downward revisions when the Bureau of Economic Analysis, or BEA, implements some new methodology changes later this year. So do you think that'll have a big impact, and how do you think the market will react to that, or is that already built into expectations?

COLLIN: I think it's already built in. So I don't think we'd necessarily expect a big market reaction. In looking at some of the potential changes, it looks like they're adjusting portfolio management and investment advice services fees. I think that's interesting because we kind of see moves in the stock market flowing through, and then a change to computer software and accessories and, I believe, legal services. I think it's probably baked in because there's no shortage of inflation indicators that are out there. And so if this one's being adjusted, we can still keep looking at other things. And also, we know that with Kevin Warsh now as chair of the Federal Reserve Board of Governors, he's looking into the whole inflation framework and what indicators we're using.

So PCE has generally been the preferred inflation gauge, specifically core PCE. But that might change over time with Warsh, or maybe he spreads out the types of indicators he's looking at. I will say this, though: It looks like the changes that they're putting in place are likely to lower the inflation indicators by a little bit, I think, maybe 0.2%, 0.3% on a year-over-year basis. That is something, if Warsh chose to pivot that way, and if that's something that we're paying attention to make the case to maybe not necessarily hike rates or maybe down the road yeah.

LIZ ANN: Yeah, probably make the case to not hike. It probably doesn't help the case to cut.

COLLIN: I don't think it makes the case to cut. When I look at the data and, if I was present at a Federal, you know, the Open Market Committee meeting, I'd love to see if anyone's actually in there advocating for a cut because it's really hard to do that right now.

LIZ ANN: Well, Stephen Miran is not on the Fed anymore, so ...

COLLIN: Yeah, a few months ago, maybe. He was very clear in his reason, though.

LIZ ANN: Yeah, he was.

COLLIN: You know, he'd dissent, and then he'd come out, he'd write a little blog post, and do a circuit explaining his why. But yeah, I think when we look at our view and maybe how it flows into what the Fed may or may not do, yeah, it's one thing that might prevent them from actually hiking as the markets are currently pricing right now.

LIZ ANN: Hey, can I ask you a question that veers into what has always been an area of expertise for you, the corporate bond market. So you know, we've been talking a lot in our group about supply-demand dynamics, especially with massive IPOs coming at a time, at least on the equity market side of things, where corporate buybacks have waned a bit.

And what does that mean from an equity-supply-versus-equity-demand standpoint? But we also have a lot of funding now of the AI boom and infrastructure build out coming through issuing corporate debt. I wanted your latest thoughts on that as it relates to supply-demand and whether there's validity to the story that some of the demand has been sort of sucked out of Treasuries and targeted toward the corporate bond market.

COLLIN: Yeah, I think there is validity there. I was on a program yesterday morning, and the anchor called this the supply monster, because it's ... there's tons of supply everywhere. And you hit the nail on the head, Liz Ann. It's not just corporate bonds. We're seeing a lot of supply by the U.S. Treasury. And this flows through to, you know, the fiscal concerns that a lot of people have. When we run persistent deficits, we need to fund those with more and more Treasury supply. So we have rising Treasury supply.

We have rising corporate bond supply. So if we look at June, this past June, the investment-grade corporate bond new issuance set a new record for June. Not a

record for all months ever, but it was a new June record. And it's already been off to a strong start. We saw another big tech company issue \$25 billion just this week alone. It's not just a U.S. story, either. You know, a lot of other governments unfortunately also have deficits and have fiscal concerns, and they're issuing more and more debt. And then when you think about these, you know, big IPOs, initial public offerings that we're seeing, there's just a lot of capital competing for attention. And I do think it's ... it is a risk. Let me let me lay out the why.

So on the Treasury side, it's something that can keep yields elevated, maybe put somewhat of a floor on our yields, and maybe even pull them a little bit higher. When we look at the risk outlook for U.S. Treasury yields, we see more factors that can pull them up versus down. And supply is one issue because when there's all these other opportunities out there, investors have to make a decision about where they want to place their money. So yields might need to stay elevated. On the corporate bond side, well, yeah, that can take away demand from U.S. Treasuries, but it could be a risk there as well because investors might start to demand higher risk premiums, or spreads, you know, the extra yields that corporate bonds offer over Treasuries to compensate for these risks because you have not just the supply-demand risk, but the risk that with a lot of these big tech companies and hyperscalers with their issuance, what's the ultimate return on these projects? And we're talking about billions upon billions of dollars.

Will these companies earn this back over the long run when they're issuing debt at, you know, maybe some debts two years and five years with maturities, some are 30 or 40 years. You know, what's that ROI, return on investment, look like? And then the same with IPOs. They make headlines. Investors tend to be interested in them. And so there's a lot of decisions that we, as investors, whether it's individual investors or institutional investors, need to make. And I think it's something that keeps yields elevated and maybe over the short run pulls up credit spreads a little bit to attract that capital.

We're still OK. So when credit spreads rise, that's a risk for corporate bondholders because it can pull prices down modestly. We think it might be more of a short-term technical blip as opposed to a sustained rise. We think corporate fundamentals are actually still pretty strong right now.

Well, Liz Ann, let's look ahead to next week as we always do, but not just from maybe a data front, but mid-July is also when we start to get a lot of corporate earnings reports. So what will you be looking for?

LIZ ANN: You know, we all look at the traditional measures of something called the beat rate, the percentage of companies that are beating consensus estimates, the

percent by which companies are beating, and comparing that to history. But I'd say it requires a more nuanced approach to looking at earnings this time. So estimates have jumped over the last few months. In early April, the consensus estimate for overall S&P earnings was about 19%, and that's up to close to 25% right now. It's not been really broad breadth in terms of where those increases have resided. Six of the 11 sectors have seen an increase in estimates since that early-April period of time, which means five have seen a decline. Biggest jumps come in energy. That's got a triple-digit expectation for earnings growth.

Tech is second to that with earnings growth expected at more than 60%. And then interestingly, basic materials is the third. So there is some concentration in terms of that improvement. But here's one of the things I'll be watching. And it's because of what we saw happen in the market in the last week or so. We don't cover stocks here, so I mention names just to put it in context. So Samsung came out and they reported earnings. And they beat consensus expectations, but they underperformed kind of the whisper number.

So one thing that I'm keeping an eye on is there's consensus expectations, and that's considered the sell side. Sell-side analysts that cover the stocks, they publish actual earnings estimates, and then things like the beat rate are calculated off that consensus. That's the sell-side consensus. But increasingly there's a buy side, maybe not consensus, because the buy side doesn't publish earnings estimates, but you get a sense of whether the whisper number, the hope, the hype, the expectations bar is being set much higher than the consensus sell-side estimates. And that sometimes can come into play in terms of what the stock does. So that's something I'm going to keep a close eye on, as well as the margin story, because we know groups like the memory stocks are posting these incredible margins. One of the rubs to having a huge margin is someone's paying the higher price. And now I'm also going to pay attention to what are companies saying about the needs to continue to invest in AI and whether they're coming up against pricing constraints or supply constraints. So some of that, you know, peel-the-onion-back analysis I'm going to look at beyond just those traditional metrics.

And then from an economic report standpoint, we get the NFIB, which is National Federation of Independent Business. That's a big think tank around small businesses. That's always got a lot of really good data. There's headline readings, but then there's also subcategories as to what's plaguing or where there's opportunities or optimism among small businesses. So I always keep a close eye on that. We get both the Consumer Price Index and Producer Price Index next week, and we get retail sales as a proxy for the consumer. What about you? What's on your radar, Collin?

COLLIN: You know, for me, I think those inflation indicators you mentioned are going to be super important, to see how the Fed might react to it. Now we don't know because the Fed is taking away their forward guidance. So whether the reports are strong, weak, or if they meet expectations, we don't know how the Fed's going to react. But it is very important. It looks like expectations for the CPI or for the monthly number to actually decrease, mainly due to the drop in energy prices. So we're going to be looking at the core readings to see if they're still, you know, rising, and if there's an inflationary pulse there. We get the Treasury International Capital data, or the TIC data, which is something we get each month, and it's a look at flows into U.S. investments. I tend to look at it more to the Treasury market to see what foreign demand looks like.

And I think it's really important to focus on this because we get a ton of questions. I'm sure you get it also, Liz Ann, about the idea of foreigners selling their Treasuries or not in being interested in their Treasuries. And that's really not the case. The data tells us otherwise. There's a few months here and there where it looks like central banks might have reduced their holdings, but for the most part, foreign investors, whether it's central banks, governments, or private investors, they're not actually dumping their Treasuries. The private investors are actually increasing their holdings over the past handful of years.

And then, finally, we get the Federal Reserve's Beige Book on Wednesday. It's more of a qualitative look. It's not a number that we can look at, but it's their qualitative look at the economy, gives insights into employment, inflation, overall economic activity. It breaks it down by each district, but then they kind of aggregate it to see what the general theme is under the surface.

LIZ ANN: That's it for us for 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. Every day that I look at imposters, it's well more than a page worth of them. So I try to block and report as quickly as possible, but it is still a big problem. And Collin, give us your socials.

COLLIN: Sure, I'm @CollinMartinCS on both X and LinkedIn. It's Collin with two L's, and the CS is for Charles Schwab. And as always, you can find our written reports, including the one we talked about from Liz Ann and Kevin about the Great Moderation, the end of that era. You can find them at schwab.com/learn.

LIZ ANN: 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'll be back next week with a new episode.

