Schwab Market Perspective: The Next Phase

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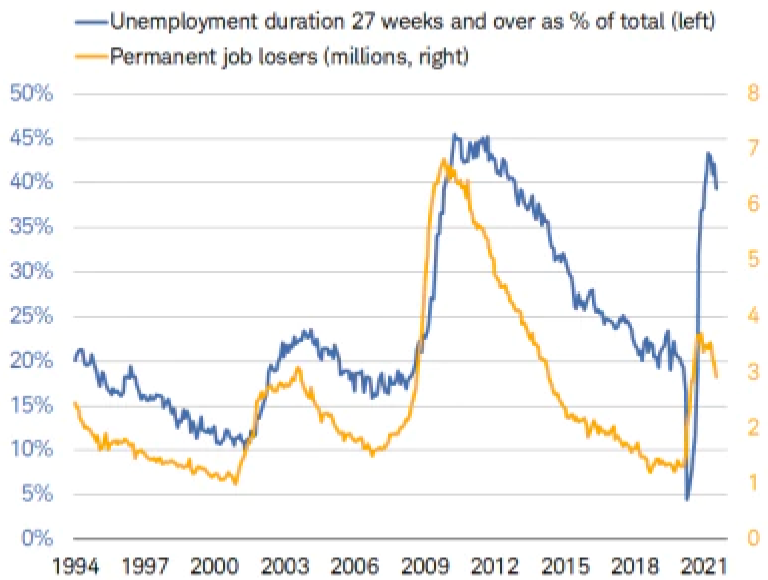
Although we're not out of the pandemic yet, the economy is showing encouraging signs. Job growth has been strong and financial markets appear to confirm that the economic cycle has shifted from recovery to expansion. Global earnings estimates are being revised upward and global business leaders are expressing fewer concerns about supply constraints than earlier this year. Given these signs, the Federal Reserve may start tapering its support for the economy sooner than expected.

Which isn't to say there aren't market risks out there, including the spread of the COVID-19 delta variant, overly bullish investor sentiment (a contrarian indicator when taken to extremes), and the return of the federal government's debt ceiling. Let's take a deeper look:

U.S. stocks and economy: Beyond the recovery phase

One of our concerns throughout the COVID-19 pandemic has been the potential for last year's business shutdowns to inflict longer-term scarring on the labor market. However, recent labor data has been positive: The U.S. economy added 943,000 jobs in July, above the consensus estimate for 870,000, while the unemployment rate declined to 5.4% from 5.9%. Permanent job losses appear to have peaked, along with the percentage of people without a job for more than 27 weeks. The reduction in long-term unemployment, drop in the unemployment rate, and record number of job openings all suggest an economy in expansionary mode.

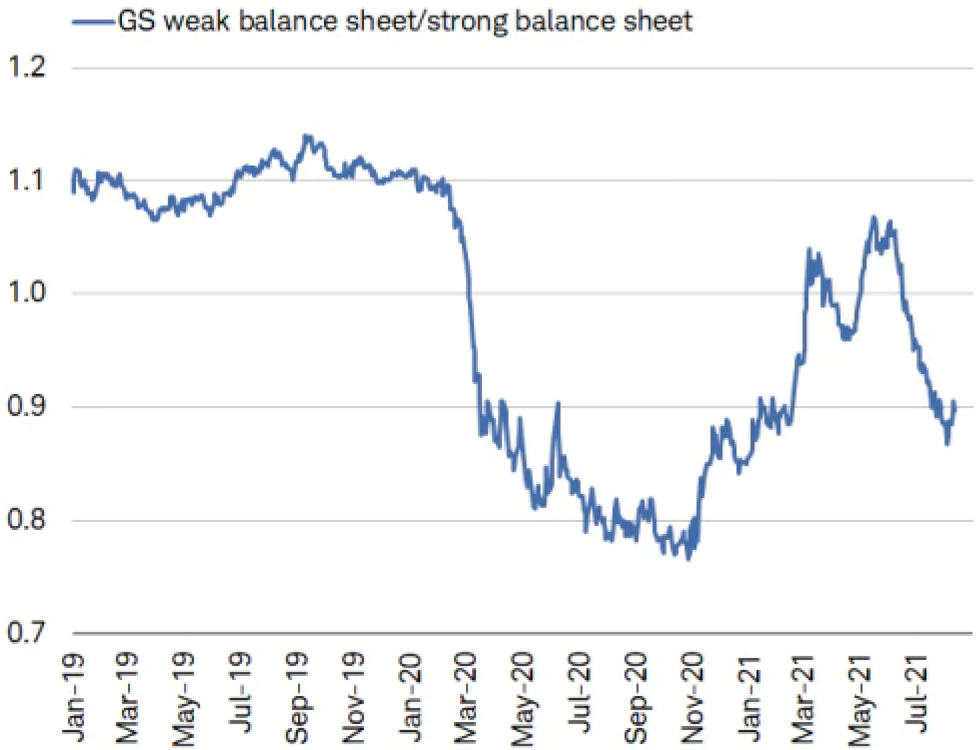
Permanent job losses appear to have peaked



Source: Charles Schwab, Bloomberg, Bureau of Labor Statistics, as of 7/31/2021.

The stock market has also confirmed that we are beyond the recovery phase, with an increasing bias toward companies with strong fundamentals Historically, as the stock market begins to price in a move from recovery to expansion, lower-quality stocks tend to benefit, as their leverage to stronger growth is high. But that phase is typically short-lived, with higher-quality stocks taking over leadership after the economy has moved into expansion mode. This cycle has been similar. As seen in the chart below, stocks with strong balance sheets have outperformed those with weak balance sheets at a brisk pace since mid-May, significantly reversing the trend in place since last October.

Companies with weak balance sheets have underperformed recently



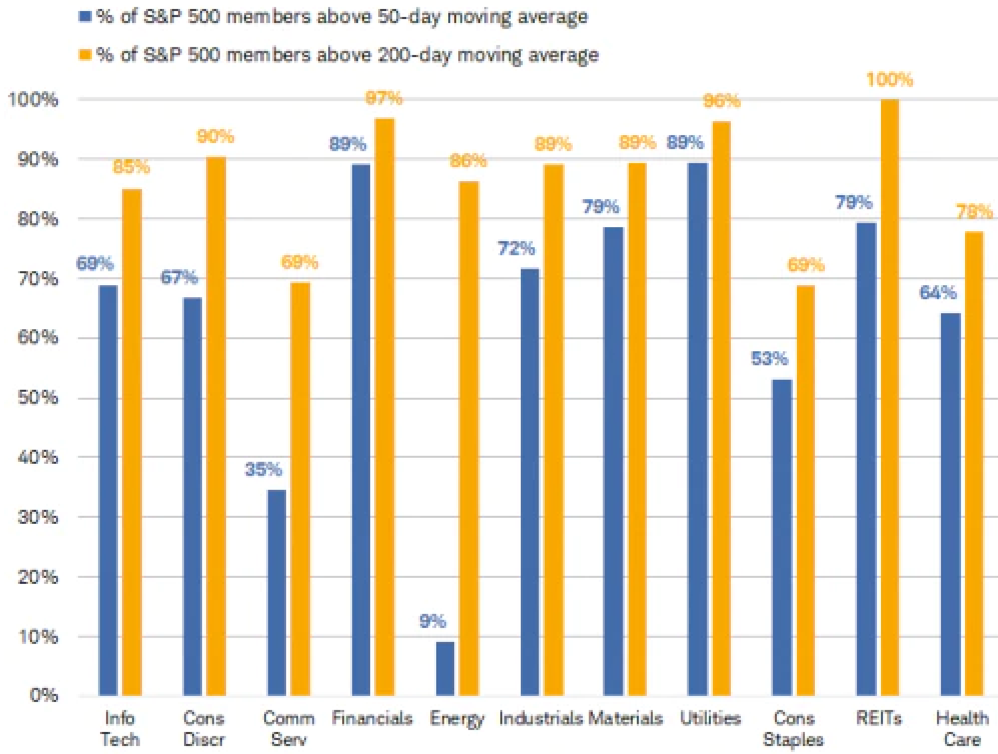
Source: Charles Schwab, Goldman Sachs, Bloomberg, as of 8/12/2021. The Goldman Sachs (GS) strong and weak balance sheet baskets each contain 50 S&P 500 companies across eight sectors with strong and weak balance sheets, respectively. Indexes are unmanaged, do not incur management fees, costs and expenses and cannot be invested in directly. **Past performance does not guarantee future results**.

As cycles mature out of the recovery phase, it's common to see investors shift their focus to fundamentals. That is true today, as most speculative trades peaked in February/March and earnings growth has continued to outpace early estimates.

However, optimism sprouting from a mostly healthy recovery has caused what we continue to believe is an ongoing risk for the market—stretched sentiment. Investors have continued to position themselves quite bullishly since last year's March lows—for example, 2021 inflows to exchange-traded funds (ETFs) topped $500 billion in late July, sailing past the 2020 record only seven months into the year. That said, we still believe that long-term breadth has continued to positively offset any weakness.

As seen in the chart below, most S&P 500 sectors are exhibiting solid long-term trends. Conversely, short-term breadth has taken a hit in some areas—most notably Energy, Consumer Staples, and Communication Services. Interestingly, those three sectors represent three different areas of the market—cyclical, newer/growth defense, and traditional defense, respectively—thus underscoring that recent deterioration has been broad-based.

Long-term sector trends remain relatively healthy



Source: Charles Schwab, Bloomberg, as of 8/11/2021. Past performance is no guarantee of future results.

For now, the dent in the number of stocks trading above their 50-day moving averages hasn't been large enough to bleed into longer-term (200-day moving average) trends. Should that happen, though, equities—particularly, those with a cyclical bias—may face heightened risks, especially as we remain in an environment of elevated sentiment.

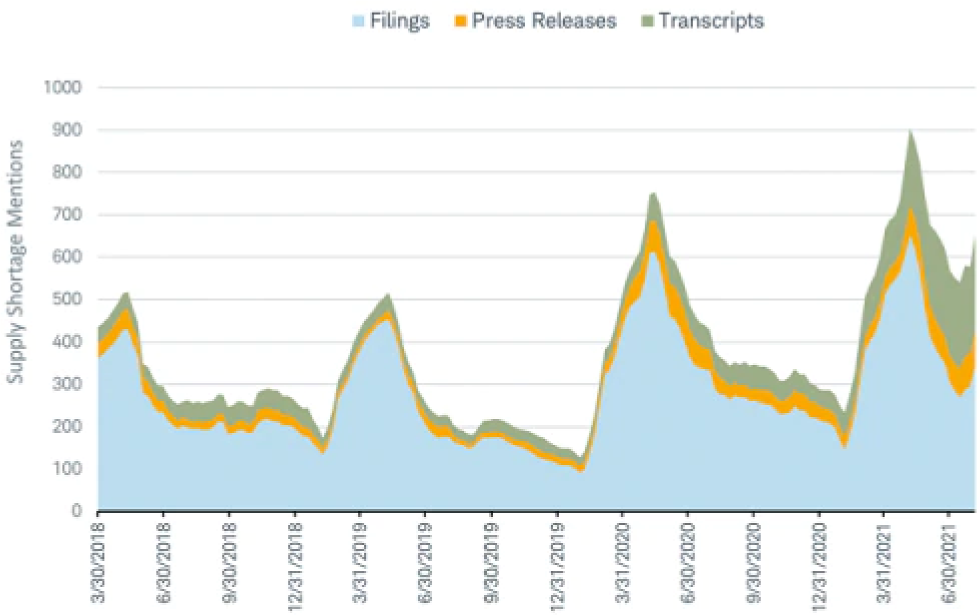
Global stocks and economy: Earnings rebound

Some international stock markets have been more focused on regulatory policy recently. However, every quarter we review the impact that developments around the world have had on the most important driver of stock prices over the long term: earnings.

Now past the halfway point in second-quarter earnings season, we can analyze the potential impact of the lingering pandemic-related supply shortages on profits going forward, relative growth expectations for the next year, and the impact on stock market valuations.

Our tracking of mentions by business leaders of shortages negatively affecting global companies (represented by the MSCI World Index) peaked three months ago on May 7, as you can see in the chart below. This led the improvement in supplier delivery times in the purchasing manager indexes subsequently reported for June and July. Improvement in supply-chain conditions could bolster confidence in future revenue estimates and support profit margins. Additionally, easing prices could mean less fear about inflation and the end of monetary stimulus, which may also aid earnings estimates.

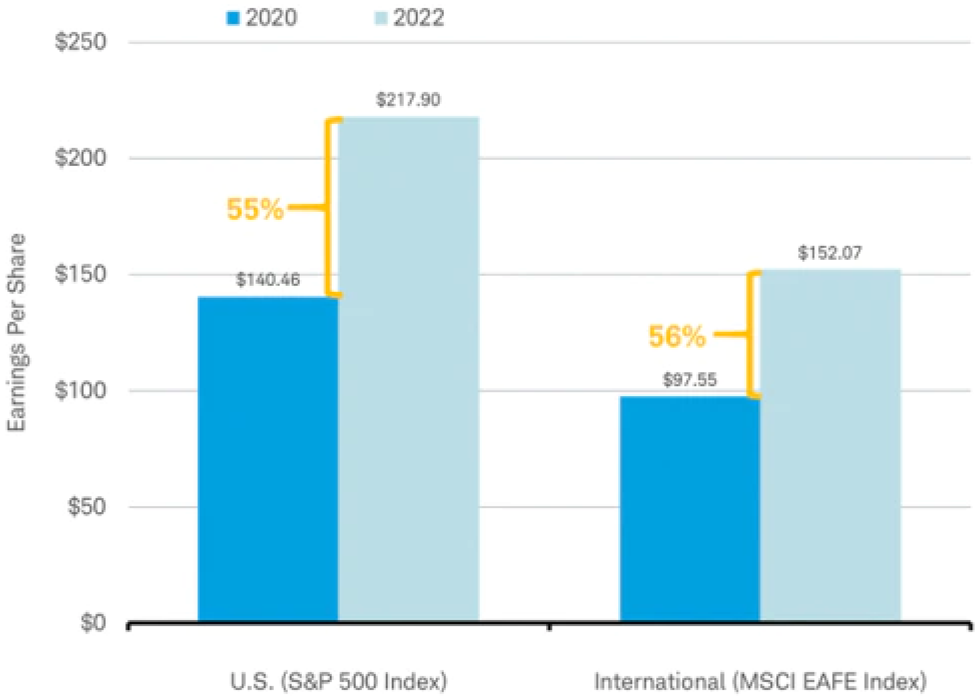
Business leaders' mentions of supply shortages peaked in May



Source: Charles Schwab, FactSet data as of 8/2/2021.

Despite market anxiety about the rapid spread of the COVID-19 delta variant, analysts continue to revise upward their earnings forecasts for the coming year. In 2021, earnings per share for both U.S. and international stocks are estimated to be above those of 2019, before the pandemic took hold. In 2022, earnings for both the U.S. and international stocks are forecasted by analysts to be 20% to 30% above 2019, and about 55% above the pandemic year of 2020, as you can see in the chart below.

Earnings-per-share growth is expected to exceed pandemic levels



Source: Charles Schwab, FactSet data as of 8/5/2021. Indexes are unmanaged; do not incur management fees, costs and expenses; and cannot be invested in directly.

The rebound in earnings has lowered stock market valuations slightly from their peak of a year ago, as measured by ratio of price and earnings estimates for the next 12 months (forward P/E ratio). But the relative undervaluation of international stocks has widened, as you can see in the chart below.

International stocks trade at largest-ever discount to U.S. stocks

Source: Charles Schwab, Bloomberg, as of 8/5/2021.

What is the result of this wide gap in valuations between U.S. and international stocks? Similarly strong earnings growth across regions, combined with more-attractive valuations, could provide a basis for international stock market outperformance, and drive a narrowing of the gap in these valuations, as it has in the past.

Fixed income: Yields climbing

The July U.S. employment report jolted the bond market out of its doldrums. The 10-year Treasury yield, which had fallen sharply to as low as 1.13% just a few weeks ago, spiked higher on signs that the job market has continued to gain momentum.

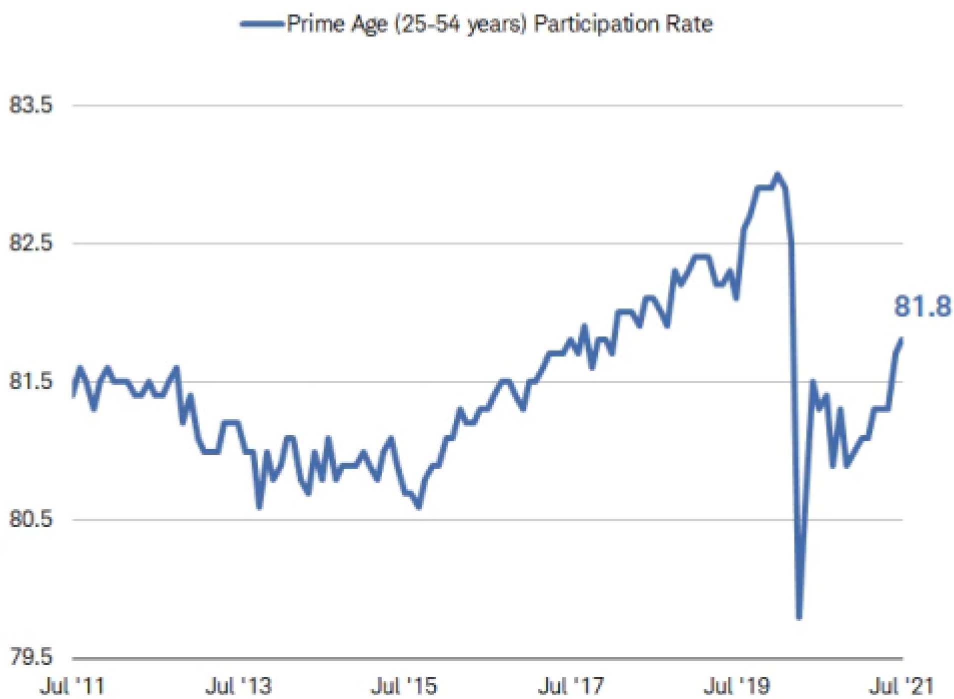
Revisiting the 10-year Treasury yield

Source: Bloomberg. U.S. Generic 10-year Treasury Yield (USGG10YR INDEX). Daily data as of 8/11/2021. **Past performance is no guarantee of future results.**

The report was strong by nearly every metric. Unemployment rates for all workers and those working part-time but looking for full-time work declined to post-pandemic lows. The number of new jobs exceeded expectations, with gains seen in the segments of the economy that have lagged throughout the recovery, such as leisure/hospitality and education. The participation rate moved higher as well, which is a significant indicator for the Federal

Reserve, as it has been keeping its policy stance very easy in hopes of stimulating a “broad and inclusive” labor market recovery. The July jobs report was consistent with that goal.

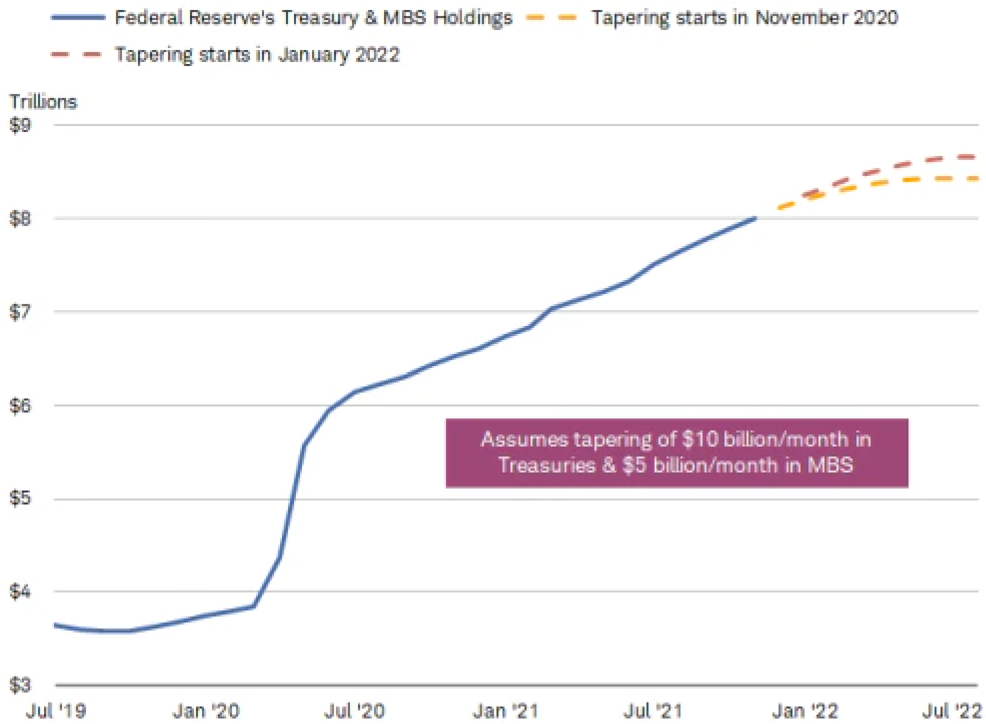
Prime-age workers continue to return to the workforce



Source: Bloomberg, using monthly data as of 7/30/2021. US Labor Force Participation Rate 25-54 Yrs SA (PRUSQNTS Index).

If the positive momentum in the job market continues, the Fed likely will move forward with plans to taper its bond purchases later this year, but it probably will require a few more good reports to confirm that the trend is intact. We expect the Fed to announce a decision on reducing its bond purchases later in the fall and to begin implementing the plan soon thereafter. Depending on the pace, it could take six to 12 months for the Fed to finish. The Fed’s balance sheet will continue to grow, however, because it will be reinvesting the interest from its bond holdings.

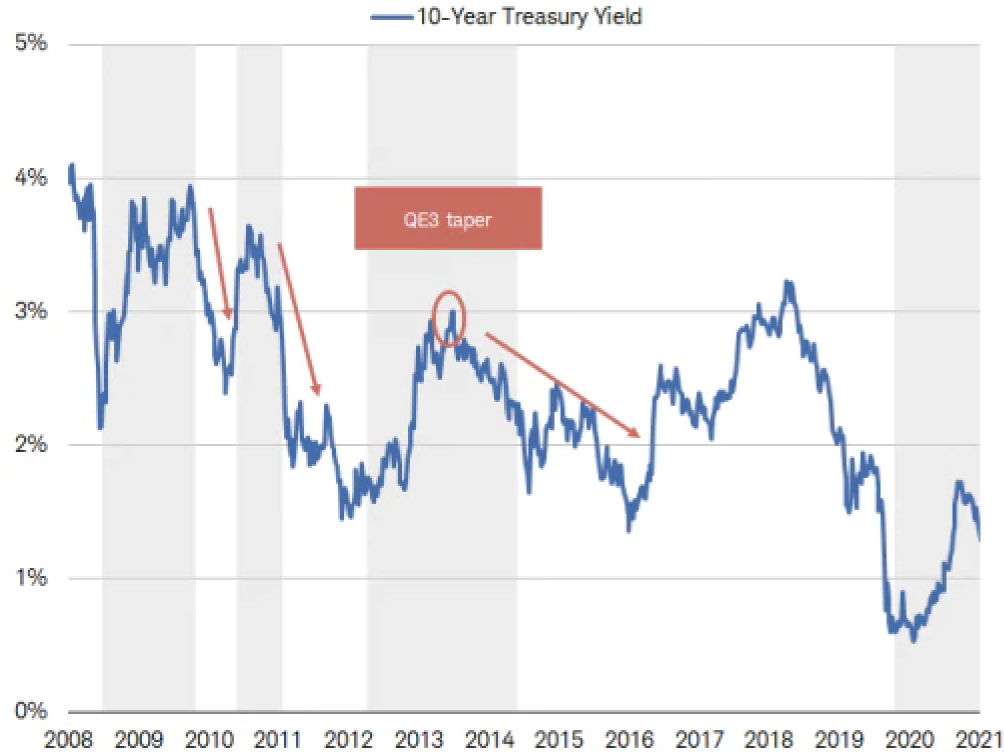
Tapering projections: Sooner and later



Source: Bloomberg. Federal Reserve Balance Sheet Securities Held Outright: Treasuries & Mortgage-Backed Securities (FARWUST Index, FARWMBS Index). Monthly data as of 7/30/2021. Forecasts contained herein are for illustrative purposes only, may be based upon proprietary research and are developed through analysis of historical public data.

While tapering isn't the same as tightening, the market has jumped ahead and priced in rate hikes beginning in mid-2022. We see that as an aggressive timeline and expect that policy tightening won't likely begin until late 2022 or 2023. Nonetheless, we expect intermediate-to-long-term yields to continue moving higher as long as the economic data confirm the recovery is gaining steam. Just the signal that the Fed may shift policy can be enough to send yields higher: In 2013-2014, when the Fed shifted to tapering its bond purchases, Treasury yields rose in anticipation of the process and fell during the implementation period.

10-year Treasury yields historically have fallen after tapering was announced



Source: Bloomberg, using weekly data as of 7/30/2021. US Generic Govt 10 Yr (USGG10YR Index). Shaded areas represent the periods of Quantitative Easing. **Past performance is no guarantee of future results.**

We see the potential for the 10-year Treasury yield to move back up to the 1.65% to 1.75% region later this year. Investors may want to consider increasing the average duration in their portfolios if yields continue to rise, instead of waiting for the Fed to begin hiking rates. In the past three cycles, the 10-year yield has peaked six to 12 months ahead of the first rate increase.

We would be somewhat cautious about the riskier segments of the bond market, such as high yield and emerging-market bonds, however. Those markets have benefited from the Fed's very easy policies, and volatility may pick up as the Fed shifts gears.

Washington: The debt ceiling returns

After a two-year break, debt ceiling worries are back—and are likely to increase market volatility as we head into the fall.

In 2019, Congress voted to suspend the debt ceiling—a cap on the total amount of debt the United States can accumulate—for two years, until July 30, 2021. The U.S. Treasury has already begun employing "extraordinary measures" to ensure the United States does not default on its debts, but those measures are likely to run out sometime in October. Congress will have to raise or suspend the debt limit by then, and there's no clear path to do so.

On Capitol Hill, Senate Republicans have said publicly that they have no plans to support a debt limit increase. Democrats, meanwhile, pointedly have not included an increase in their budget reconciliation package, insisting that they will only have a bipartisan effort.

In a late-July letter to Congress, Treasury Secretary Janet Yellen said the Treasury could run out of money to pay its bills "soon after" lawmakers return to Washington in September, but notably did not set a specific date. Outside analysts have estimated the deadline will be reached by mid to late October.

This is something of a rhetorical game of chicken, but the uncertainty around when and whether Congress will act is almost certain to spark significant market volatility, as it has in past debt ceiling standoffs. The most significant crisis happened in 2011, when Congress waited until the very last moment to avoid default. The Cboe Volatility Index spiked and yields on 10-year Treasury notes fell. The crisis peaked when Standard & Poor's downgraded the credit rating of the United States for the first time ever, leading to what at the time was one of the most volatile weeks in the market's history. Market unrest was a huge factor in finally pushing Congress to act just days before the country went into default. This scenario repeated itself, with varying degrees of volatility, during debt ceiling debates in 2013, 2017, 2018, and 2019.

The bottom line is that while the path to addressing the debt ceiling is unclear at this time, Congress has always managed to find a way, and the expectation is that they will do so again in 2021. But investors should be prepared.

Michael Townsend, Managing Director of Legislative and Regulatory Affairs, and Kevin Gordon, Senior Investment Research Specialist, contributed to this report.

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Managing Director, Chief Investment Strategist, Charles Schwab & Co., Inc.

As Managing Director and Chief Investment Strategist at Charles Schwab, Liz Ann has a range of investment strategy responsibilities, from market and economic analysis to investor education, all focused on the individual investor.

CFA®, Managing Director, Chief Global Investment Strategist, Charles Schwab & Co., Inc.

As Managing Director and Chief Global Investment Strategist at Charles Schwab, Jeffrey is responsible for analyzing and discussing international markets, trends, and events to help investors understand their significance and financial implications. He provides research, commentary, and actionable insights to Schwab's client-facing teams and the firm's Investor Services and Advisor Services clients.

Managing Director, Chief Fixed Income Strategist, Schwab Center for Financial Research

As Managing Director and Chief Fixed Income Strategist for the Schwab Center for Financial Research, Kathy is responsible for interest rate and currency analysis as well as fixed income education for investors at Schwab. Jones has covered global bond, foreign currency and commodity markets extensively throughout her career as an investment analyst and strategist, working with both institutional and retail clients.

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