Schwab Market Perspective: Tension

Competing narratives have emerged to describe the state of the U.S. economy.

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The tug-of-war over the economic outlook continues, as investors wait to see whether the Federal Reserve will raise its benchmark policy rate again this year. The picture is not clear: While some sectors have weakened, others have remained resilient. Amid the uncertainty, bond market volatility and 10-year Treasury yields remain elevated.

Meanwhile, Chinese data has been surprisingly strong as government stimulus takes hold, which may lift sentiment and stocks of companies with China exposure. However, given the problems in its property market, China's economic growth is unlikely to see a V-shaped rebound.

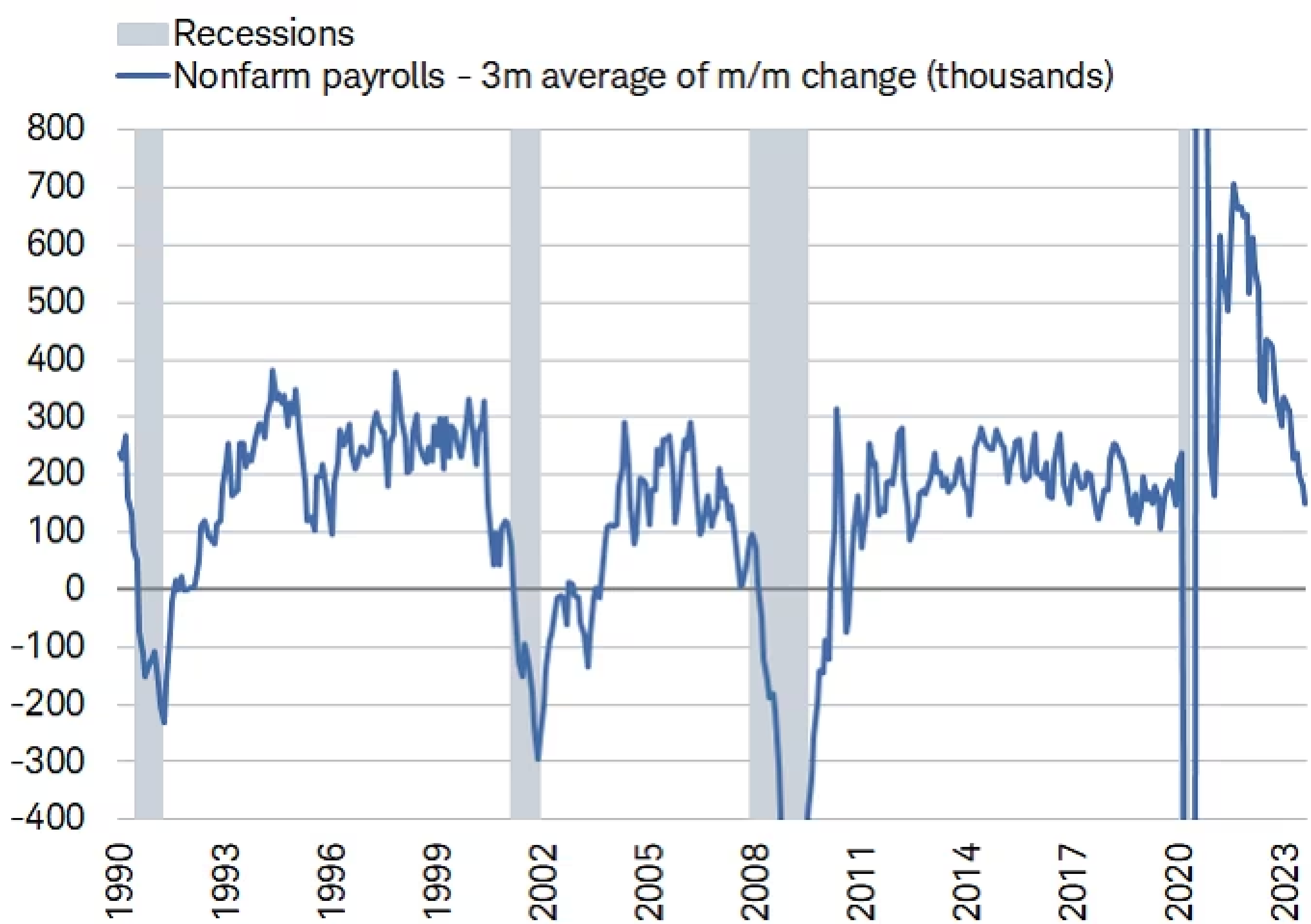
U.S. stocks and economy: The downside of data dependency

Given mixed economic indicators, competing narratives have emerged to describe the state of the U.S. economy. This is in line with our view that the U.S. has been experiencing rolling recessions that affect certain industries or geographies—different from an official national recession[1]—for most of the past year and a half. While there have been noticeable declines in areas like housing and consumer goods, those pockets of weakness have been more than offset by resilience in services and the job market.

Yet it's worth noting that job growth, a key pillar of U.S. economic resiliency, has been slowing rapidly lately. Payroll growth has slowed considerably since the post-pandemic re-opening phase in 2021. Looking at the three-month average of monthly job gains, the fall to 150,000 in August marked the lowest since the COVID-19 pandemic began in March 2020. This is mostly in line with the average seen during the past few economic expansions, but the pace of decline this year has been sharper than what is typically seen in an expansion.

This underscores an important aspect of economic data that investors should always consider: It's often the case that "better" or "worse" tend to matter more than "good" or "bad" when it comes to shifts in the economy. Investors should pay as much—if not more—attention to rates of change.

Payroll growth has slowed markedly



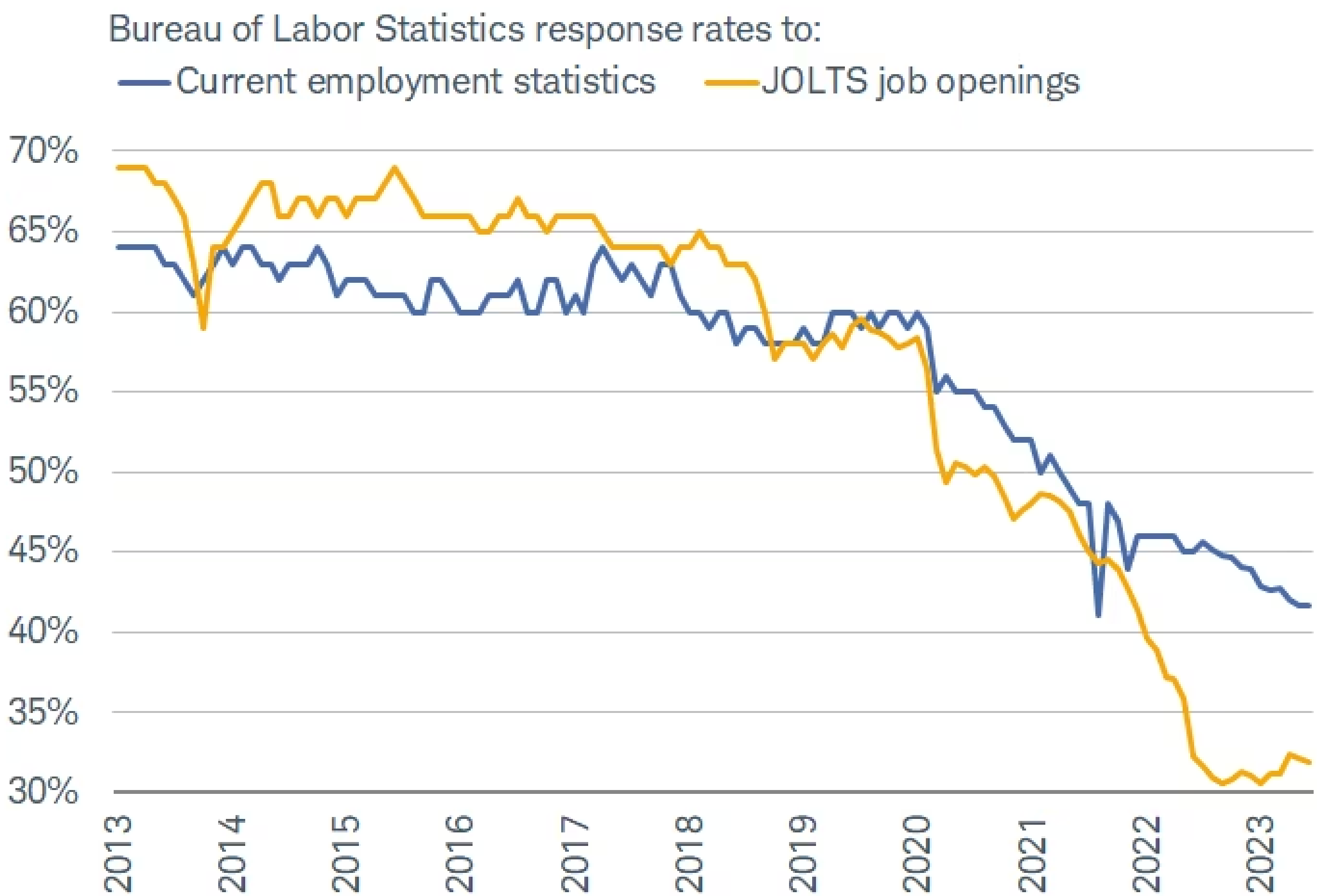
Source: Charles Schwab, U.S. Bureau of Labor Statistics, Bloomberg, as of 8/31/2023.

Y-axis is truncated for visual purposes. Recessions are determined by the National Bureau of Economic Research.

One of the issues with being acutely data-dependent these days is that response rates for survey data remain incredibly low relative to the pre-pandemic era. As shown in the chart below, response rates for the

Bureau of Labor Statistics' (BLS) monthly jobs report and job openings data have dropped sharply. That is understandable given the disrupting nature of the pandemic, but also troubling given the Federal Reserve's reliance on labor data to gauge the effectiveness of its monetary policy. While lower response rates are a bit worrisome, the BLS has still been able to provide revisions to prior months' data, which have confirmed that the labor market is cooling down. This is reinforced by supplementary data such as slowing wage growth and hiring demand.

BLS is waiting longer for a response



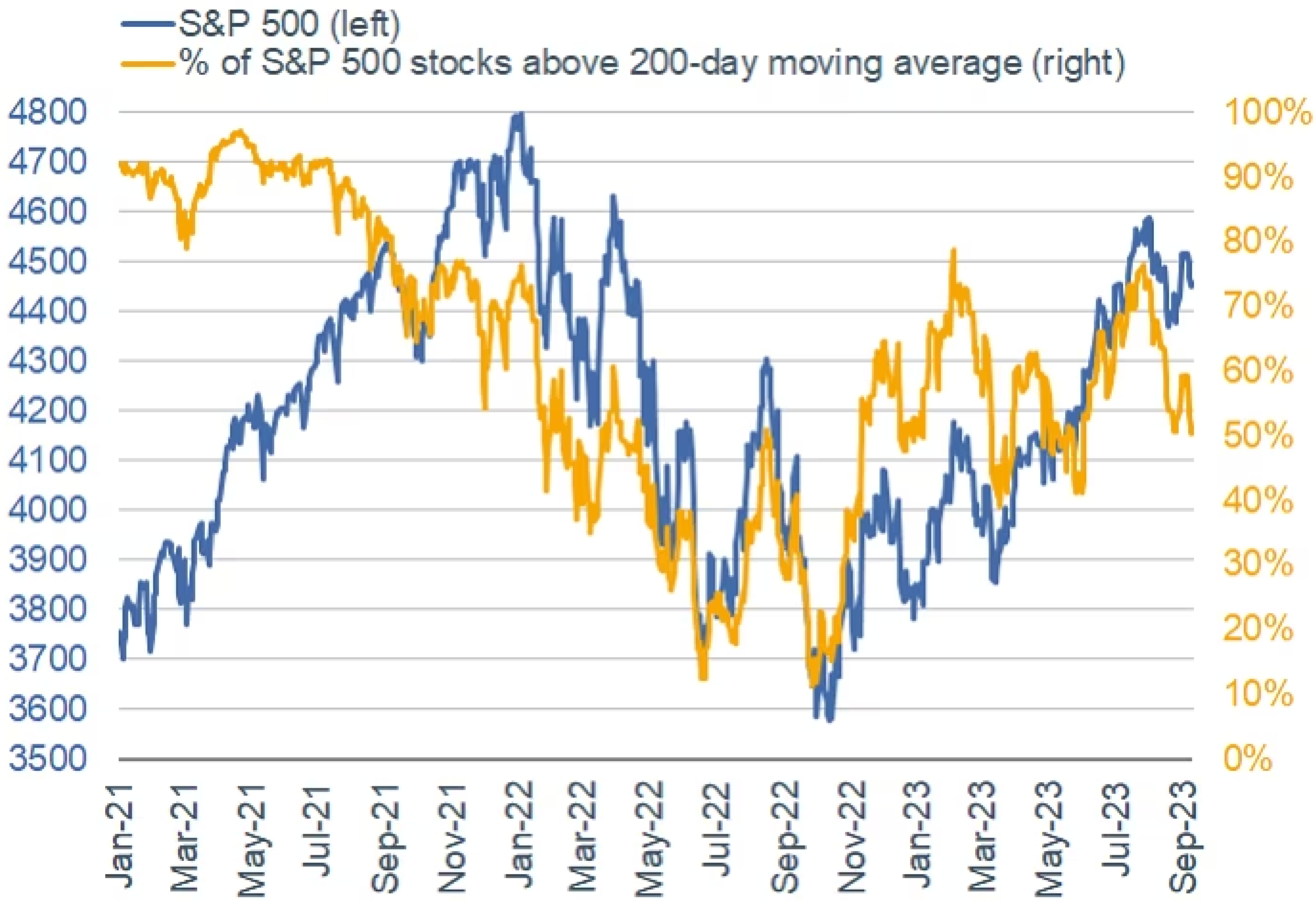
Source: Charles Schwab, Bureau of Labor Statistics (BLS), Bloomberg, as of 6/30/2023.

Historically, survey response rates have been used as a measure of how representative a survey is of the sampled population. Response rates of surveys don't relate well to nonresponse bias, but the pattern of the response rates may give insights into survey processes. The Job Openings and Labor Turnover Survey (JOLTS) program produces data on job openings, hires, and separations.

A sustained downshift in payroll growth would continue to raise the recession antennae and pose a risk to some economic sectors that have showed nascent signs of stabilizing. As is consistent with history, spreading labor weakness would likely coincide with the same fate for the stock market. Until that point, though, one of the best ways investors can be on the lookout for market weakness is by looking at breadth.

As shown in the chart below, the percentage of S&P 500® index members trading above their 200-day moving average has fallen sharply since the end of July. Market breadth has been rather unimpressive so far this year, even though the S&P 500 itself has mostly trended higher. A continued divergence would be worrisome and reminiscent of the backdrop in late 2021. At that time, waning strength below the surface correctly signaled that the rally for the S&P 500 was losing steam.

S&P 500 breadth has not matched performance lately



Source: Charles Schwab, Bloomberg, as of 9/8/2023.

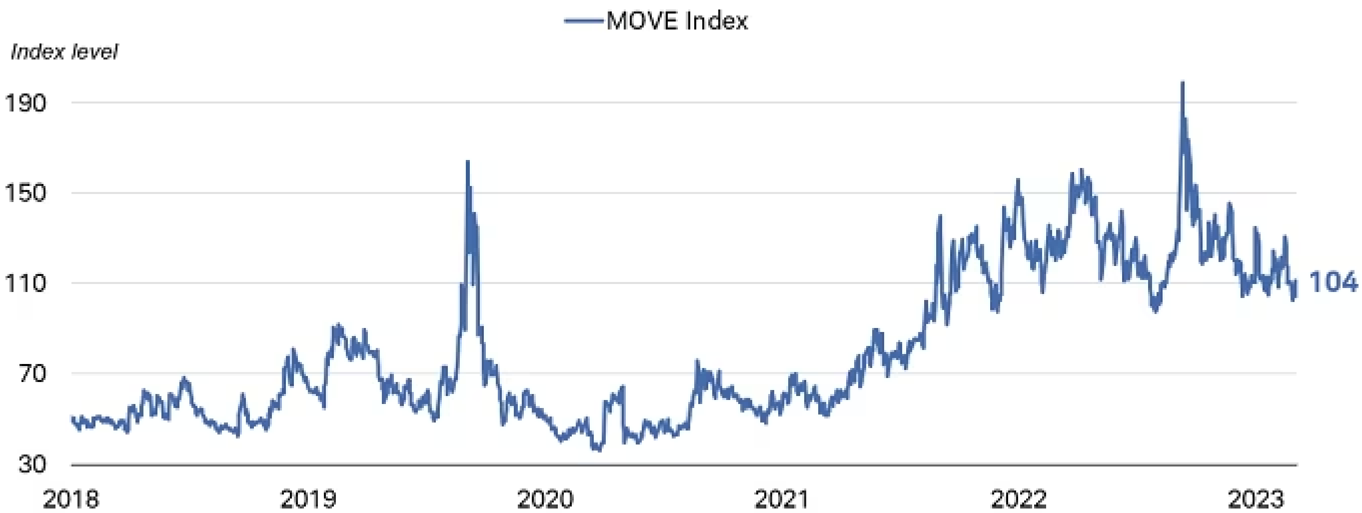
The 200-day moving average calculates the simple average of the closing price of a stock over the most recent 200 trading sessions. The line drawn from those numbers shows the trend of a stock over a long duration. Indexes are unmanaged, do not incur management fees, costs and expenses and cannot be invested in directly. **Past performance is no guarantee of future results**.

Fixed income: Bond market remains volatile

Despite recent good news on inflation, the bond market can't seem to muster a sustainable rally. Short-term yields remain near rate-hike-cycle highs, reflecting the potential for another rate hike by the Federal Reserve before the end of the year. Intermediate- to long-term yields have been trading in a broad range. Over the past month, any sign that the economy was growing at more than a modest pace has sent yields higher, while cooling inflation pressures has sent them lower. Additional worries center around rising budget deficits, which require the Treasury to sharply increase issuance at a time when the Fed is reducing its balance sheet[2] and yields are rising in other countries.

As a result of these uncertainties, bond market volatility remains elevated. At a reading of 104 index points, the Merrill Option Volatility Estimate (MOVE) index—a measure of bond market volatility—is down from recent peak levels above 190, but is still well above the pre-pandemic average of about 75.

The MOVE index has declined but is still above pre-pandemic levels

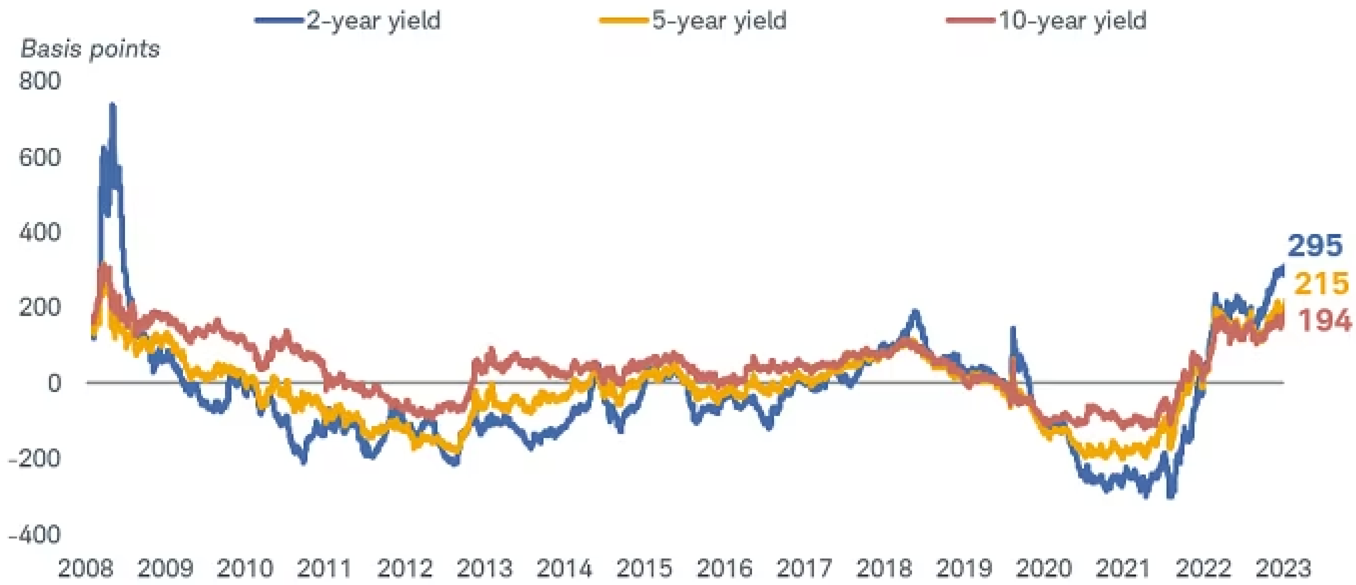


Source: Bloomberg. Daily data as of 9/8/2023.

The MOVE index is a market-implied measure of bond market volatility that calculates the implied volatility of U.S. Treasury options using a weighted average of option prices on Treasury futures across multiple maturities (2, 5, 10, and 30 years). **Past performance is no guarantee of future results**.

We expect volatility to remain high until there is a clear indication that the Fed can end its rate hikes. However, it's worth noting that even when rate hikes stop, the Fed will still be tightening policy in other ways (such as balance sheet reduction). Real interest rates—adjusted for inflation expectations—will continue to rise as long as inflation is slowing. High real rates tend to discourage business and consumer spending by raising the cost of capital. Real rates are already at the highest levels since 2009.

Real Treasury yields are at the highest levels since 2009



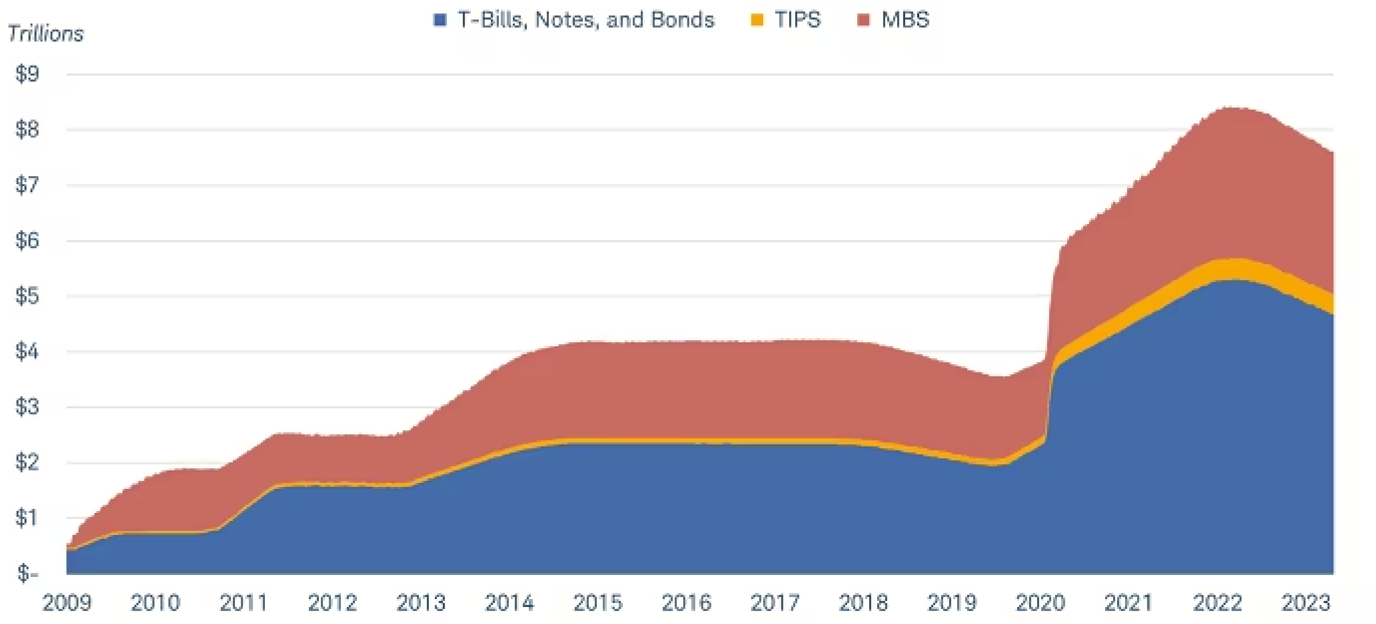
Source: Bloomberg, daily data as of 9/11/2023.

US Generic Govt TII 2 Yr (USGGT02Y INDEX), US Generic Govt TII 5 Yr (USGGT5Y Index), US Generic Govt TII 10 Yr (USGGT10Y Index). **Past performance is no guarantee of future results**. A basis point is 1/100th of a percentage point, or 0.01%, meaning 200 basis points would be equal to 2%.

The impact of rising rates is showing up in the drop in demand for loans—especially by small- to medium-sized businesses, whose profit margins tend to be lower compared to big companies. Because small businesses account for the bulk of hiring in the economy, the ripple effect of higher rates is starting to show up in a slowdown in employment growth.

In addition, the Fed is still reducing the size of its balance sheet through its "quantitative tightening" program, allowing the bonds it holds to mature without reinvestment. A smaller balance sheet tends to reduce the quantity of reserves in the banking system, which should mean slower growth in lending. The Fed's bond holdings have declined by about $1 trillion since the peak in April 2022, which equates to a drop to 31% of gross domestic product (GDP) from 37.5%.

The Fed's balance sheet has declined



Source: Bloomberg, Federal Reserve, weekly data as of 9/6/2023.

Reserve balance on Wednesday close for Treasury bills, Treasury notes, Treasury bonds, Treasury Inflation-Protected Securities (TIPS) and mortgage-backed securities (MBS).

It's unclear how long the Fed will continue quantitative tightening. There have been discussions that a balance sheet of 20% to 25% of GDP would be the target, but there doesn't appear to be an explicit target level yet. There are risks that moving ahead too quickly will create a shortage of reserves in the system, as it did in 2019.

Looking ahead, the bond market is still facing hurdles that could drive yields higher and keep volatility elevated. However, in the long run, inflation is still likely to be the major driver behind the direction of yields. We continue to expect that the cumulative impact of the Fed's tightening policy to date is enough to keep inflation trending lower.

Global stocks and economy: China surprises

Global stocks, as measured by the MSCI All Country World Index (ACWI), sold off 3% in U.S. dollar terms in August, with China worries taking center spotlight. The MSCI China Index slid more than 8%. Markets with material sales exposure to China underperformed (MSCI Korea Index -8%, MSCI Brazil Index -8%, MSCI Taiwan Index -4%, MSCI Germany Index -5%, MSCI France Index -4%, and MSCI Australia Index -4%), implying that what's next for China may have a broad impact on global markets and the global economic outlook.

China's growth problem lies in its property market, which is estimated to have contributed as much as 29% of GDP in recent years. Developers' actions and comments suggest they are starved of capital both in terms of debt issuance and cash flows from new property sales. Concerns have increased about losing down payments, which are typically made years before delivery of a completed unit. Because property comprises about 70% of wealth for Chinese households (according to analysis of data from China's National Bureau of Statistics), worries about the housing market appear to be eroding overall consumer confidence and the pace of spending on goods.

China consumer confidence back at lockdown lows

Source: Charles Schwab, Bloomberg data as of 9/7/2023.

The China consumer confidence index is based on a survey of 700 adults from 20 cities across the country. The composite index covers the consumer expectation and consumer satisfaction index, thus measures the consumers' degree of satisfaction about the current economic situation and expectation on the future economic trend. The Index measures consumer confidence on a scale of 0 to 200, with 200 indicating extreme optimism, zero indicating extreme pessimism, and 100 representing neutrality.

To address the housing-driven downturn China has enacted an almost daily drip feed of targeted stimulus measures, especially since the July Politburo meeting. As these incremental policy measures begin to bear fruit, there could be some positive surprises in the September releases of the official August data. We've been pointing to the unseasonable rise in China's air pollution as a real time a sign of renewed manufacturing activity.

Rising air pollution in China may be signaling a manufacturing rebound

Source: Charles Schwab, U.S. State Department, Bloomberg data as of 9/7/2023.

The Average for China Air Quality Index (AQI) is published by the U.S. Department of State and developed by the U.S. Environmental Protection Agency (EPA). EPA converts readings of particulate matter that is 2.5 micrometers or smaller (PM 2.5) via formula into air quality index value. The blue line reflects the change in the index since the beginning of January 2023, shown in 4-week increments. The gray line shows the average change between 2016 and 2022.

Thus far, we have seen the China Caixin Manufacturing PMI for August surprise the Bloomberg-tracked economists' consensus estimate to the upside, moving back into growth territory to 51 index points from 49.2 (a reading above 50 indicates expansion, while below 50 indicates contraction). The leading new-orders component of that index suggests more to come. Also, China's exports and imports rose sequentially in August, with year-over-year trade growth above the consensus forecast. This rebound in export growth was broad-based across major trading partners and products.

Given the property market overhang, China's economic growth is unlikely to see a V-shaped rebound. Yet, more stimulus announcements and upward surprises suggesting they are beginning to work could lift sentiment and stocks with China exposure.

[1] In the U.S., recessions are determined by a committee of experts at the National Bureau of Economic Research. They take into account a number of monthly indicators such as employment, personal income, industrial production and gross domestic product growth. The last U.S. recession occurred from February 2020 to April 2020, precipitated by the COVID-19 pandemic. Recessions often are not identified until they are well underway, and in some cases they have ended before the NBER officially recognizes them.

[2] The Federal Reserve has been reducing its balance sheet (also known as "quantitative tightening") by not buying new securities to replace securities that are maturing. This reduces overall demand for government-backed and mortgage-backed securities, leading to higher interest rates, and also reduces the amount of cash in the financial system.

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The MSCI Korea Index is designed to measure the performance of the large and mid-cap segments of the South Korean market. With 102 constituents, the index covers about 85% of the Korean equity universe.

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The MSCI Taiwan Index is designed to measure the performance of the large and mid-cap segments of the Taiwan market. With 90 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in Taiwan.

The MSCI Germany Index is designed to measure the performance of the large and mid-cap segments of the German market. With 59 constituents, the index covers about 85% of the equity universe in Germany.

The MSCI France Index is designed to measure the performance of the large and mid-cap segments of the French market. With 63 constituents, the index covers about 85% of the equity universe in France.

The MSCI Australia Index is designed to measure the performance of the large and mid-cap segments of the Australia market. With 59 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in Australia.

The Caixin China General Manufacturing Purchasing Managers' Index (PMI), sponsored by Caixin and compiled by international information and data analytics provider IHS Markit, is based on data compiled from monthly replies to questionnaires sent to purchasing executives in over 500 manufacturing companies. A reading above 50 indicates expansion, while a number below 50 points to contraction.

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