Research > Markets

Markets

Schwab Market Perspective: Further Fuel?

Liz Ann Sonders
Senior Vice President, Chief Investment Strategist, Charles Schwab & Co., Inc.,
Brad Sorensen
CFA, Director of Market and Sector Analysis, Schwab Center for Financial Research, and
Michelle Gibley
CFA, Senior Market Analyst, Schwab Center for Financial Research
January 14, 2011

Key points

- Stocks may be vulnerable to a near-term pullback thanks to elevated sentiment, and earnings season could provide an impetus for some profit taking. Looking ahead, however, the economy appears to be strengthening and we remain optimistic.
- Despite the economy showing signs of growth, the Federal Reserve seems insistent on seeing its second round of quantitative easing (QE2) play out, pointing to continued high unemployment and housing as issues still dragging on growth. The new US congress also has to deal with these issues, while attempting to pare deficit spending at the same time.
- International exposure is important for investors, but we recommend taking some profits and rebalancing if your emerging-market exposure gets above your target allocation.

Now that the new year has begun, focus has shifted from political issues to the economy and corporate health as fourth-quarter earnings season heats up. Expectations for earnings have ramped up during the past couple of months as estimates have moved in concert with better economic data.

Ironically, the pre-release positive momentum could set up for disappointments relative to elevated expectations, possibly providing the impetus for some profit-taking.

Sentiment (typically a contrarian indicator) remains extended as bullishness among investors is extremely high. However, despite the possibility of some near-term volatility, we remain optimistic as we look to the balance of 2011.

With the Fed still stimulative, tax cuts extended and expanded, confidence slowly returning to the corporate sector and positive seasonality trends (the third year of a presidential cycle is typically the best for the stock market), we believe stocks will continue to perform well.

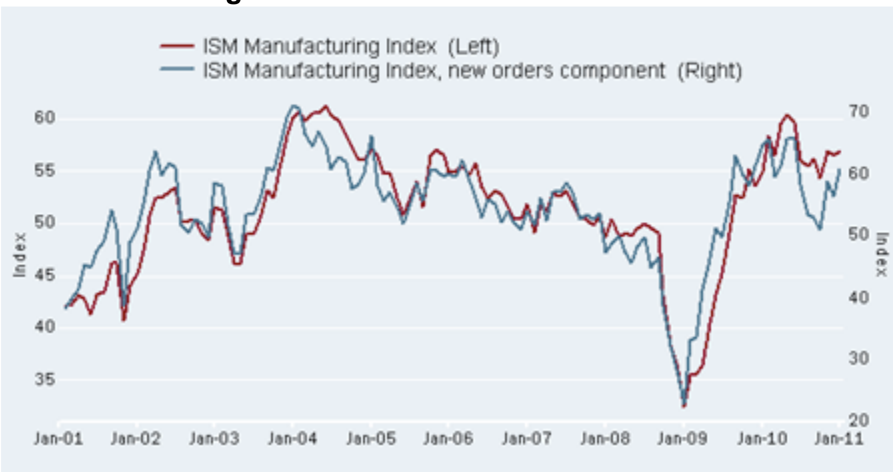
We've already seen mutual fund flows begin to shift from bonds to stocks, and we believe this trend will continue as investors grow tired of the low (but rising) yields and increasing risk of falling prices in the bond market.

Economic growth continues

Boosting our confidence in stocks is the continued strength we're seeing in the US economy. Since the start of the year, the Chicago Purchasing Managers' Index posted a 22-year high reading at 68.6.

The wider-ranging Institute of Supply Management's (ISM) Manufacturing Index rose to 57 in December, well above the 50 mark that signals expansion. Perhaps even more importantly, the new orders component of that report, an indicator of future activity, rose to 60.9—a seven-month high.

Continued Strength Indicated



Click to enlarge
Source: FactSet, ISM, as of January 11, 2011.

The news was equally encouraging from the services sector, which makes up the lion's share of the US economy, as the ISM Non-Manufacturing Survey rose from 55 to 57.1—the highest rate of expansion since May 2006.

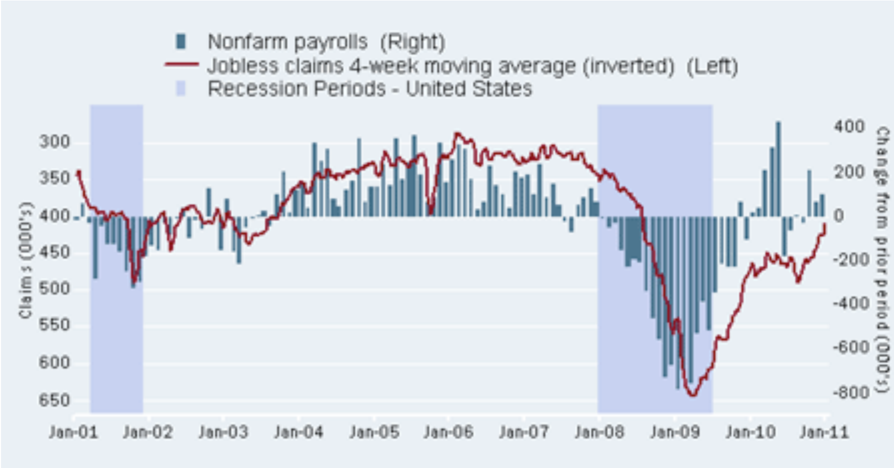
Of course, not all is rosy, and there are still concerns regarding major segments of the economy, including housing and state and local municipal debt issues. However, it's these concerns that can help to keep in place at least some of the "wall of worry" that markets so often like to climb.

The unemployment rate is still high, though it did drop a significant 0.4% in the latest report, from 9.8% to 9.4%. This was the 20th time in history that the rate plunged that much and only once did the decline reverse and head back up.

We're cautiously optimistic that we're starting to gain some traction in employment as the four-week moving average of initial jobless claims (a leading economic indicator) continues to move lower.

Additionally, the Automatic Data Processing report of private payrolls reported a December gain of 297,000 jobs, almost three times the consensus estimate. That said, payroll growth remains anemic and must improve before the economy (and confidence) can really pick up.

Positive Sign for Jobs



Click to enlarge
Source: FactSet, U.S. Department of Labor, as of January 11, 2011.

The news on housing is less encouraging:

- The recent S&P/Case-Shiller Index of home prices showed year-over-year declines for the fourth straight month.
- Mortgage rates have moved higher, recently touching seven-month highs.
- The latest existing home sales report failed to meet muted expectations.

We still believe we'll avoid a "double dip" in housing broadly, but the risks are rising and there will still be geographical pockets of more weakness. Foreclosures are accelerating and banks continue to hold houses on their balance sheets that will eventually have to be put on the market for sale, adding to already-bloated inventories.

We believe housing is slowly healing and it's going to take time, but a renewed substantial dip in housing is one of the bigger risks we presently see in the market.

Policymakers moving in opposite directions

It seems highly unlikely the federal government will step in as it has done in the past to try to provide support to the housing market. With the new US congress in place, attention is now focused on ways to cut spending in an attempt to pare massive deficits and debt.

Of course, it's easier said than done. Much of the problem lies in so-called entitlement spending such as Medicare and Social Security, and neither seems likely to be addressed in the near term.

However, attacking the deficit through cutting spending or raising taxes alone doesn't solve the crisis. We believe stimulating economic activity will help grow tax revenues as more income is earned and fewer people rely on government "help."

To this end, we're encouraged that the tax cuts were extended for two years, though we'd like to see a more permanent structure to enable businesses to better plan for the future. We're also encouraged by talk that a corporate tax cut could be coming in the near term.

Contrary to austerity measures being considered by Congress, the Fed seems intent on remaining extremely stimulative. It remains concerned about employment and, despite clear improvement in the economy in the past few months, noted in its recent Federal Open Market Committee meeting statement that there's a "high bar" in place to end QE2 early.

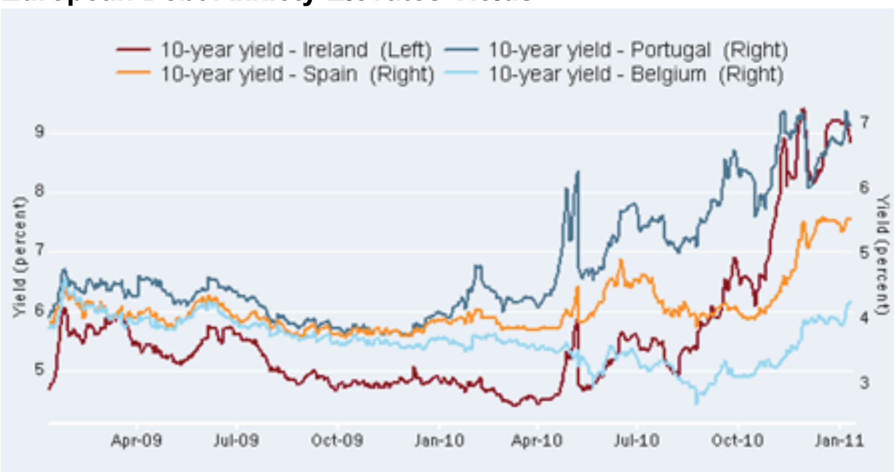
With so much money presently in the system, we continue to watch measures of velocity of money to determine if the Fed's policies are actually helping by increasing lending activity. We still believe, despite current rhetoric, that there's a small chance the program will end sooner than expected if unemployment continues to fall and/or core inflation heats up.

European debt—same story, different actor

In contrast to the United States, which has a proactive central bank and more time to address its debt situation, the euro-zone remains in crisis, primarily due to a common currency that can't adjust for economies operating at different speeds and the lack of flexibility of the European Central Bank (ECB).

Last year saw bailouts of Greece and Ireland, and the current microscope is on Portugal. Meanwhile, yields on Spanish and Belgian debt are also spiking higher.

European Debt Anxiety Elevates Yields



Click to enlarge
Source: FactSet, iBoxx, as of January 11, 2011.

While high euro-zone debt and deficits need to be addressed, the lack of coordination and strong support by European policymakers to address the "crisis of confidence" is propelling the situation into a self-fulfilling prophecy. Investor concerns result in rising yields, increasing debt funding costs to unsustainable levels—rates above nominal economic growth result in growing debt burdens.

Confidence is low in part because of ongoing talk of making bondholders share in bailout pain, inadequate progress by governments toward deficit-reduction targets, and because the ECB has made only small, reactive purchases of government debt. Current bailout mechanisms are insufficient if contagion spreads to the larger economies and the government debt markets of Spain and Italy, and as more nations become unable to assist in bailouts due to bailouts of their own.

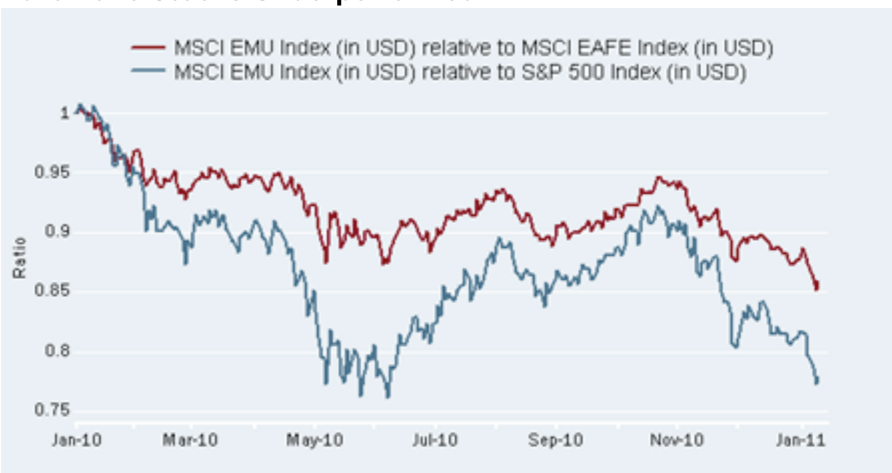
Economic growth in the euro-zone will likely trail that in the United States due to European fiscal austerity and the combination of reduced spending and tax increases, while the United States is benefitting from continued monetary stimulus.

We've consistently said that policymakers need to make bolder, more proactive moves to address investor confidence. On this front, German politics appear to be a little less contentious, which could pave the way for progress.

A more-comprehensive solution could include modification to the current European Financial Stability Facility that includes some combination of access to lower interest rates, increased size of bailout funding, debt repurchases, short-term loans and debt guarantees.

If markets gain some confidence, a more-comprehensive solution can be reached and government yields should fall to more sustainable levels, meaning additional bailouts could be avoided. This would likely be met with a rally in euro-zone stocks due to current inexpensive valuations and low expectations, along with previous underperformance.

Euro-zone Stocks Underperformed



Click to enlarge
Source: FactSet, MSCI, as of January 11, 2011. Indexed to 100 as of December 31, 2009. A number less than one denotes greater underperformance of the European Monetary Union (EMU) relative to each respective index.

US dollar largely influenced by the euro

The European debt crisis has resulted in episodes of weakness in the euro and thus US dollar strength, an "anti-euro" trade. A resolution to the European debt crisis could result in renewed US dollar weakness, although there are many factors that play into near-term currency movements.

Additionally, while China is likely to continue to diversify away from its heavy exposure to US dollar assets, the United States is unlikely to lose its reserve currency status anytime soon. The US dollar remains an important currency in trade transactions and the US Treasury market is the largest and most-liquid debt market in the world.

However, China's moves deserve attention, and several new policies announced this year indicate currency reform has accelerated. China is gradually allowing its currency, the yuan, to be used outside of its borders. Recent reforms include allowing exporters keep revenues in overseas bank accounts and the state-owned Bank of China allowing US investors to trade the yuan.

However, these are gradual moves, and it will be quite some time (if ever) before the yuan becomes a credible alternative to the US dollar. Currently, the exchange rate remains controlled by the Chinese government, not markets.

Volatility while composition of China's economy changes

Chinese economic growth has continued to shine, largely because the government has directed investment in infrastructure and allowed high levels of bank lending at low rates to assist the economic recovery.

However, continued large amounts of money plowed into increasingly less-economically viable infrastructure projects and investments, particularly given over-capacity in many industries, is not a good economic strategy. Meanwhile, domestic consumer spending remains a relatively small portion of the economy and income inequality is growing.

As such, the new Chinese five-year growth plan is likely to address inequality issues in housing, incomes and social safety nets. Additionally, 2011 policy is focused on increasing the flexibility of the yuan and containing lending that could fuel bubbles and expose banks to risks.

Strong economic growth, as well as overly stimulative interest rates and lending, has stoked inflation fears. While some measures of China's inflation show signs of moderation, risks remain.

In particular is the risk of wage inflation due to tight job markets and the desire to reduce income inequality. Minimum-wage hikes have been ordered and worker unrest has resulted in businesses raising salaries.

We expect Chinese stocks to remain subject to uncertainty regarding the amount and aggressiveness of monetary tightening, and the degree of economic slowing China will experience in 2011.

Emerging-market concerns

Many emerging markets are struggling with the impact of food inflation given that food constitutes a higher proportion of spending than in developed markets. Food inflation can erode consumer discretionary spending and create the expectation of rising prices across an economy.

Lower discretionary spending, along with the need for monetary tightening to fight broader inflation, can combine to dramatically slow economic activity, particularly in countries with large contributions from consumers. Stocks in countries facing this dual dilemma, such as India, Indonesia and South Korea could underperform.

Emerging-market stocks outperformed in 2010, due to strong returns in a number of smaller markets and the asset class receiving strong inflows of money. We moved to a more-neutral view on emerging markets in November, concerned about high expectations and valuations.

We're seeing the impact of high expectations on the markets of India and Bangladesh in 2010, both experiencing notable declines. We still like the longer-term emerging-markets story, but we believe growth needs some time to catch up with prior stock performance. We remind investors that emerging-market allocations should be a small part of a diversified portfolio and investments should be made with a long-term time horizon.

Important Disclosures

The MSCI EAFE® Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the United States and Canada. As of May 27, 2010, the MSCI EAFE Index consisted of the following 22 developed market country indexes: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

The MSCI Emerging Markets IndexSM is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of May 27, 2010, the MSCI Emerging Markets Index consisted of the following 21 emerging-market country indexes: Brazil, Chile, China, Colombia, the Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand and Turkey.

The S&P 500® index is an index of widely traded stocks.

Indexes are unmanaged, do not incur fees or expenses and cannot be invested in directly.

Past performance is no guarantee of future results.

Investing in sectors may involve a greater degree of risk than investments with broader diversification.

International investments are subject to additional risks such as currency fluctuations, political instability and the potential for illiquid markets. Investing in emerging markets can accentuate these risks.

The information contained herein is obtained from sources believed to be reliable, but its accuracy or completeness is not guaranteed. This report is for informational purposes only and is not a solicitation or a recommendation that any particular investor should purchase or sell any particular security. Schwab does not assess the suitability or the potential value of any particular investment. All expressions of opinions are subject to change without notice.

The Schwab Center for Financial Research is a division of Charles Schwab & Co., Inc.

(0111-0637)

Brokerage Products: Not FDIC Insured • No Bank Guarantee • May Lose Value

Account: XXXX-X875
Today's Date: 01/18/11 02:39 PM EST