Gliding to Year End?

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Key Points

> - Equities have had a great 2013 to this point and we are now in a period of the year that is traditionally positive for stocks. The risk of a pullback is always present, but we believe such an event would be relatively minor and represent an opportunity to add to equity exposure. We also believe there is a risk of a melt-up…remember, as good as they feel, they don't end well.
> - The implementation of the Affordable Care Act has been a debacle by nearly all accounts, likely further impacting business confidence. Budget rhetoric will heat up again into early 2014, but we don't believe a repeat of the October shutdown is likely. The Fed continues to be extremely accommodative, and inflation readings are putting little pressure on them to change policy in the midst of a leadership shift; although a small taper of their bond purchases is likely by early 2014.
> - European policy makers are concerned about falling inflation but we don't believe deflation is imminent. The Japanese war on deflation seems to be gaining traction although the fight is at a critical juncture; while China's government seems to be tightening control but promising market reforms, we're hopeful but somewhat skeptical.

NOTE: Due to the Thanksgiving holiday, the next scheduled Schwab Market Perspective is December 13, 2013.

What a year…to this point. But 2013 has another six weeks or so to go that investors have to navigate. Traditionally, the last part of the year is a good one for equity markets (especially after such a strong first 10 months). But sentiment has become a bit frothy, suggesting a pullback could occur at any time. In fact, recently we've seen markets trade more in a sideways pattern, which we view as a positive as it gives a chance for gains to be digested by the market, and may help the elevated sentiment readings cool off a bit. Sentiment is a valuable tool, but isn't a perfect market timing mechanism as optimistic sentiment can remain elevated for some time.

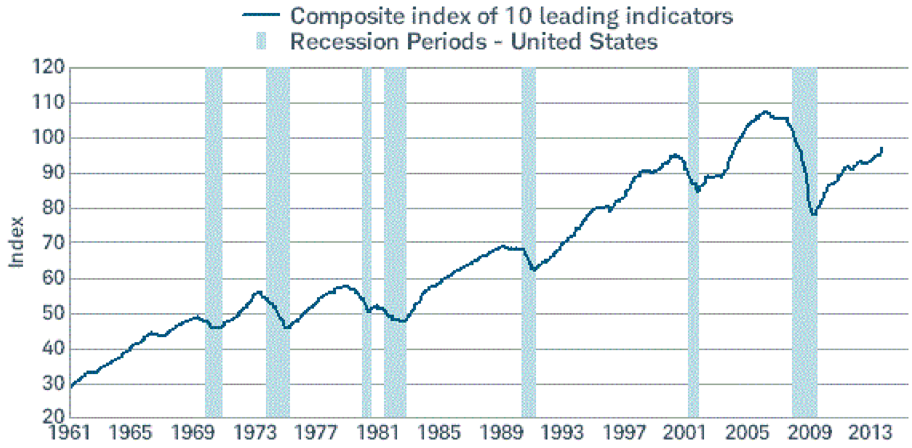
We always strongly recommend that investors take a long-term view with regard to equity investing. However, those investors who have money on the sidelines looking for an opportunity to invest should use pullbacks to put that money to work. There's still quite a bit of money on the sidelines and limited attractive options for earning income on that money, which we believe increases the attractiveness of US equities.

Economy still appears supportive

Our optimism is underpinned by improving economic fundamentals. We remain in a modest growth mode, which helps alleviate fears of recession, but doesn't force the Federal Reserve to move quickly to tighten monetary policy—sort of a Goldilocks situation for equities (not too hot and not too cold). Additionally, low inflation—still below 2% year-over-year on the core CPI reading—tends to support higher valuations of stocks, leading us to believe this bull market still has further to run.

Although economic data is still a bit lumpy from the government shutdown, it's starting to clear and is continuing to show that modest growth story. There were, however, a couple of readings that could be a harbinger of accelerating growth heading into next year as the Institute for Supply Management's (ISM) Manufacturing Index surprisingly rose to 56.4 from 56.2 in November, with the new orders reading ticking higher to a robust 60.6. Also, the ISM Non-Manufacturing Index rose to 55.4 from 54.5, with the employment component jumping from 56.2 from 52.7. We also saw the Index of Leading Economic Indicators post yet another positive reading, indicating further economic expansion.

LEI pointing to further growth

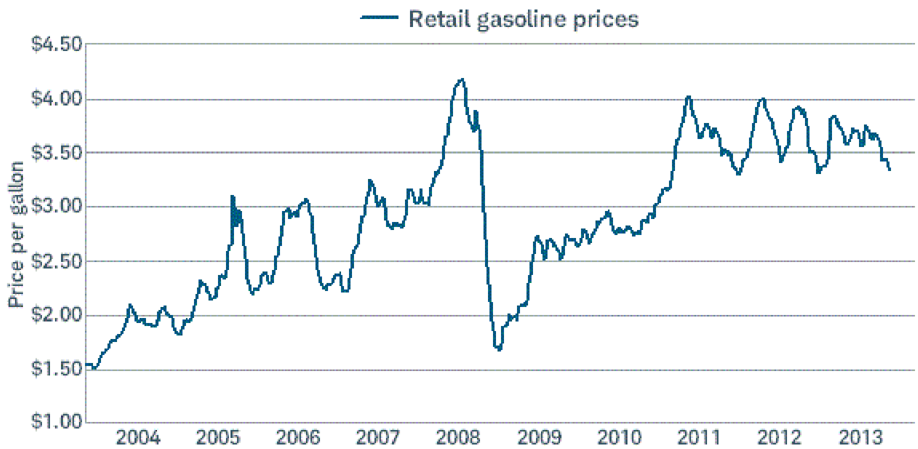


Source: FactSet, U.S. Conference Board. As of Nov. 12, 2013.

The job market has improved while better jobless claims indicate the possibility of accelerating growth in the coming months. The most recent Labor Report surprised on the upside and showed that 204,000 jobs were added in October, while the unemployment rate edged up to 7.3% from 7,2%—although that rise was attributed to the government shutdown. Additionally, the previous two months were revised up by a combined 60,000 positions. One number in the report, however, that may give the Fed some pause, was the labor force participation rate falling to 62.8%—the lowest level since 1978.

Consumer spending will likely now take the spotlight as we head into the holiday shopping season. There was some concern that the government shutdown would impact holiday spending, but we've seen consumer confidence show signs of rebounding, leading us to believe there will be little actual impact. Additionally, there appear to be some tailwinds developing that could boost holiday spending beyond relatively muted expectations. The so-called "wealth affect" could bolster spending as stocks have risen impressively over the past few years, while home prices have also posted nice gains. Additionally, the labor market continues to improve, albeit slowly, and the recent drop in fuel prices should put more money in consumers' pockets.

Falling gas prices should be a tailwind for holiday spending



Source: FactSet, U.S. Dept. of Energy. As of Nov. 12, 2013.

Calm between storms?

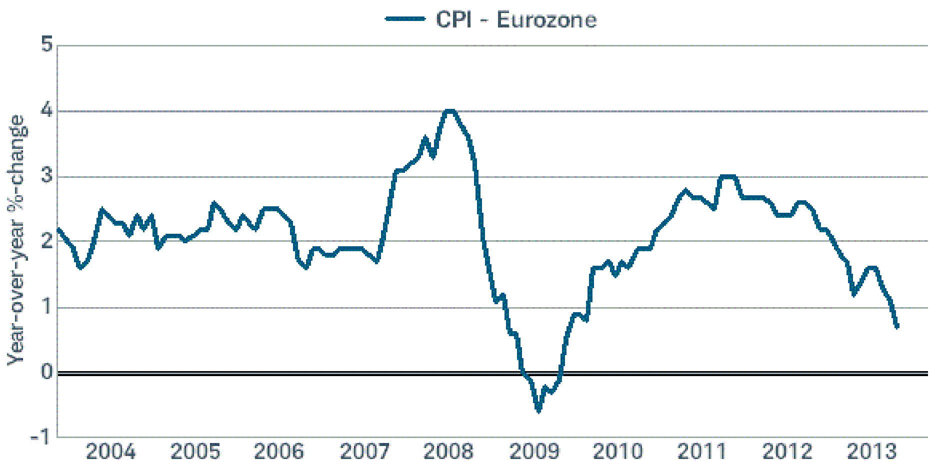
While off the front pages for now, the budget and debt ceiling debates will heat up again heading into 2014. While we don't believe there will be a "grand bargain", we also don't think there will be the kind of brinksmanship that damaged both parties the last time around. However, there is the possibility of a smaller deal that would reduce the near-term impact of the ongoing sequestration that could alleviate some of the fiscal drag on the economy in 2014. The most recent contribution to business and consumer frustration from the Federal government has been the implementation of the Affordable Care Act (ACA)—deemed a debacle by nearly all accounts. The technology issues were in the spotlight, but there was also issues with consumers getting kicked off their plans unexpectedly; and concerns whether enough young people will sign up; a necessity to make the ACA viable. It does appear something will be done about the broken pledge around individuals keeping their insurance, but other substantive changes remain in doubt.

With all of this going on, it still appears to us that the Federal Reserve will hold off on cutting back its asset purchases until after the New Year, when the new Fed chair will be installed. However, there is not an insignificant chance that they could move at their December meeting; leading to the possibility of increased volatility should Fed members start to prepare the market for such an occurrence.

Is Europe turning Japanese?

The eurozone's recovery has lagged the US recovery and has been quite meager, driven primarily by exports. Domestic demand has been weak, lending to non-financial corporations fell by 2.7% in September, and inflation softened to only 0.7% in September. Such a low level of price increases, or disinflation, has prompted concerns that deflation (an outright fall in prices) is a risk.

Concern inflation too low in the eurozone



Source: FactSet, Eurostat. As of Nov. 12, 2013.

The low level of inflation in September appeared to have spooked the European Central Bank (ECB) into cutting interest rates in November. The ECB now believes the eurozone could experience a "prolonged period of low inflation" as they witnessed "broadly-based" low inflation extending to services and non-energy industrial goods. October's two-year high in the euro also likely played a part, as a strong euro puts downward pressure on import prices and therefore inflation.

Why was the ECB spooked by the low level of inflation? The risk is that if inflation continues to undershoot the ECB's "below but close to 2%" definition of price stability, inflation expectations could become "unanchored" and begin to fall. When consumers expect prices to be lower in the future, they often postpone purchases, resulting in a negative price spiral that reduces sales for businesses, job cuts, and reduced consumer spending. Once a deflationary mindset sets in, it is difficult to reverse, which is why central banks have a tough time fighting deflation.

Deflation is associated with Japan and many are beginning to question if the eurozone is the next Japan. We believe there are significant differences between the eurozone and Japan's lost decades, but concede that eurozone growth could be slow for a long time without more structural reforms, in Italy and France in particular, and a healthier banking system.

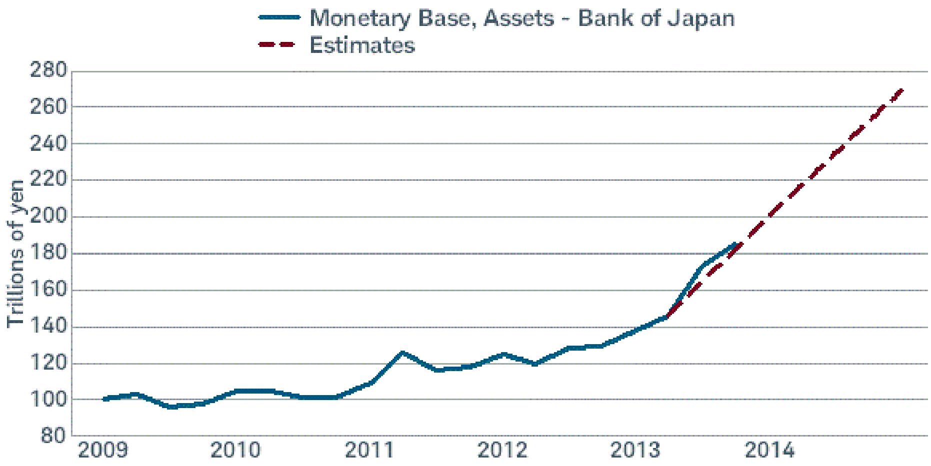
Despite our view that growth will be slow in the eurozone, we expect it to continue to improve, and we have a positive view on European stocks. Many of Europe's companies are global, with strong competitive positions in the luxury, technology and industrial industries. Profit margins are depressed, having declined since the beginning of 2008, unlike in the United States, where profit margins are at a 45-year high. We believe profit growth could exceed revenue growth, and help narrow the performance gap between US stocks and European stocks. Read more in our Europe article.

Skepticism Japan's past is behind them

Unlike in the eurozone, where deflation is now a threat, inflation appears to be taking hold in Japan. While this is the desired effect of the Bank of Japan's (BoJ) quantitative easing (QE) program, there are also risks. Economic growth has moderated after a torrid pace, and headwinds to consumer spending are building, which accounts for roughly 60% of the economy. The BoJ's QE program has resulted in a weaker yen and pushed up food and energy prices. Additionally, the sales tax is slated to increase in two-stages beginning in April 2014 and wages are still falling.

Policymakers in Japan in the past have reversed course too soon, prematurely cutting off recoveries, and investor doubts about "Abenomics" have crept in. Recent areas of concern include a slowing in the pace of expansion of the BoJ's balance sheet and a stalling of progress on Abe's "third arrow" of structural reforms.

Japan's money expansion flattened recently



Source: FactSet, Bank of Japan. As of Nov. 12, 2013.

Investors are likely to adopt a "wait-and-see" attitude toward Japanese stocks until the BoJ's balance sheet returns to its forecasted trend growth and more decisive structural reforms are tackled.

Transformation of China's economy will likely have to wait

Expectations about reforms to China's economy were high going into the Chinese government's Third Plenary Session in early November; billed by policymakers as bringing a "comprehensive plan" and an "unprecedented" scale and depth of reform.

The 5,000 Chinese-character communiqué after the meeting disappointed many, as it seemed to be very general in nature and more of a wish list than a plan. While the government upgraded the role of markets to a "decisive" role from a "basic" role in the economy, they also noted that the state would retain a "dominant" role. A committee was formed to study "comprehensively deepening reform," while "decisive" results are expected by 2020.

Whether the blueprint results in policies that transform China's economy is not yet known, it may not be for many months and perhaps years to come. We see reasons to be optimistic, as changes to rural property and migrants' rights could unleash consumer spending and another spike up in urbanization. Reducing bureaucracy could improve the business environment for entrepreneurs, but there are also signs the government is tightening its grip on the country.

If policymakers aggressively pursue reforms, economic growth could sharply downshift in the near-term, but the result would likely be higher quality, more sustainable growth, improving the longer-term outlook. If policymakers delay reforms, growth could slow at a more gradual pace; but growth is likely to be lower quality, making the economy more vulnerable to a hard landing in the future as the current economic model is running out of steam. The longer China's transformation is delayed, accumulating risks likely increase.

In the near term, signals about China's economy are not confirming the government's official message of recovery. Commodity prices are soft, despite the economic strengthening in the third quarter being led by infrastructure and property spending, and recent announcements of increased spending on railway construction and reconstruction of "shantytowns." Monetary policy appears to have a tightening bias, with interbank rates rising and loans slowing. Defensive sectors of the stock market are leading, and property stocks are lagging, indicating Chinese stocks could fall further.

While we believe China and roughly 60% of the emerging market countries in the stock universe have structural headwinds, sentiment and valuations are fairly low. This leaves us with a neutral view on Chinese-related investments, including emerging markets stocks, as discussed in our article.

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So what?

Although we remain optimistic, the path to year-end may have some potholes. We still believe US stocks are among the more attractive investment options available, but there is the risk of a pullback in the near term should sentiment conditions continue to be elevated. There is also a risk of a melt-up in stocks given recent momentum. As good as they feel while they're happening, they don't tend to end well. A market that continues to grind higher and experience sporadic pullbacks is healthier from a longevity perspective. Europe is dealing with falling inflation and weak growth, although expectations are low, leaving investment opportunities somewhat attractive. Both Japan and China appear to be at a crossroads and we are watching political and monetary developments carefully.

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