Watching the Shape of the Recovery

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U.S. stocks have been fairly resilient lately, even as coronavirus hotspots flare up around the country. Although consumers and businesses are increasingly worried about rolling shutdowns, major stock indexes generally have moved sideways. How long can this continue? Much depends on the shape of the economic recovery.

Global stocks have held onto their gains, as well. There may be an incentive for investors in some countries to anticipate that an economic slowdown—perhaps a W-shaped recovery instead of a V-shaped one—wouldn't be so bad because governments could step in and buy stocks.

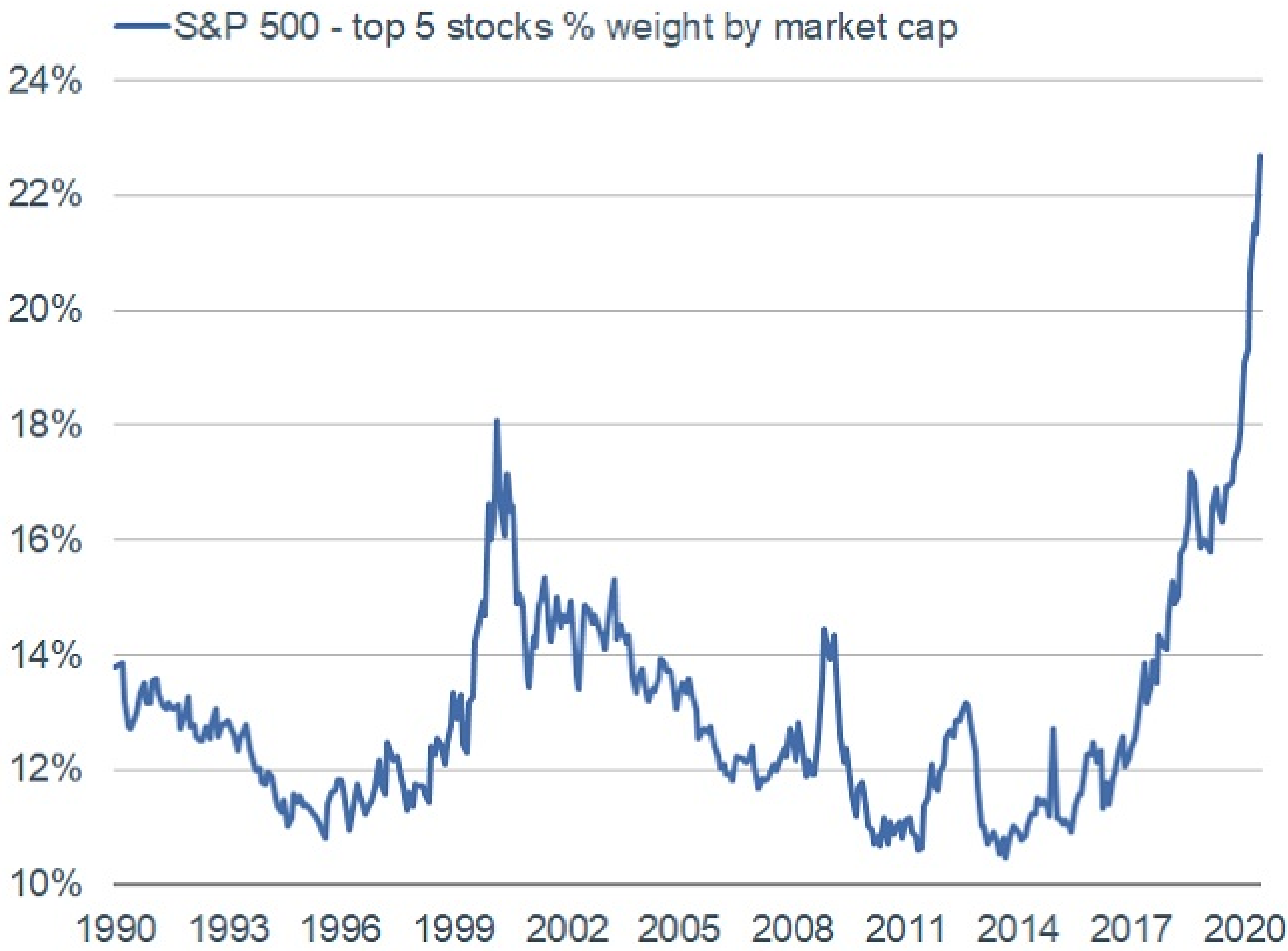
In fixed income markets, we expect second-half returns to be driven more by coupon income than price gains, and by government fiscal policy rather than central bank monetary policy. This would be basically a reversal of what happened in the first half.

U.S. stocks and economy: V- or W-shaped recovery?

With key parts of the U.S. economy still ailing and coronavirus case growth rising, some investors and market watchers have grown skeptical of the market's resilience. Looking at the market's internal conditions, some of the skepticism seems valid. Market breadth in particular has turned quite weak since early June. A declining number of stocks within the S&P 500® index are trading below their 50- and 200-day moving averages.

Also, the top five stocks in the S&P 500 (by market capitalization) have grown to more than 22% of the index, a degree of concentration that is higher than during the dot-com era that preceded the early-2000s tech bust.

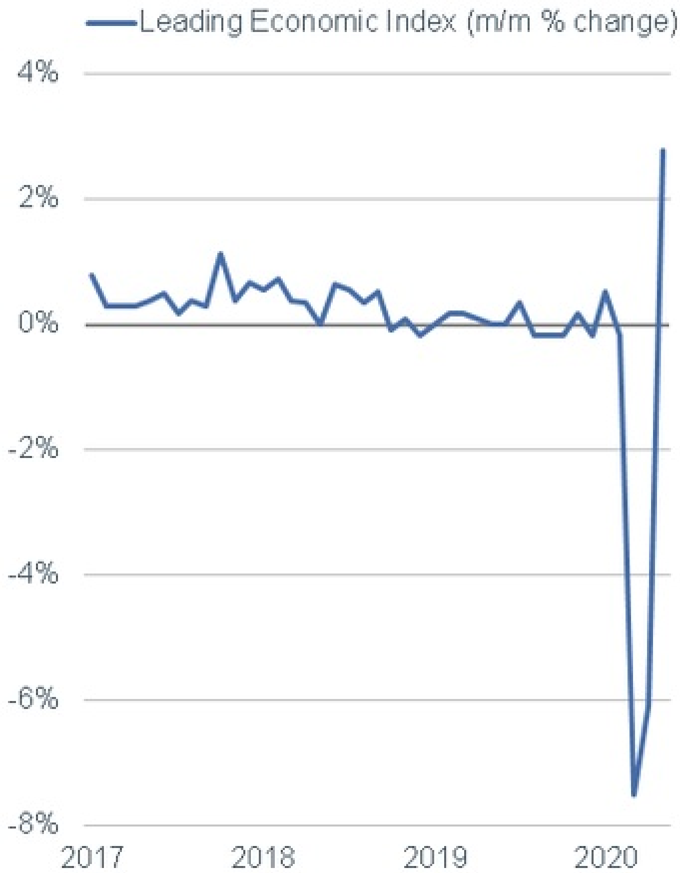
The five largest S&P 500 stocks now make up more than 22% of the index



Source: Charles Schwab, Bloomberg, as of 6/30/2020. **Past performance is no guarantee of future results**.

The S&P 500 has rallied sharply since its March 23 low, as segments of the U.S. economy have reopened in some capacity. The initial reopening efforts led to surges in economic data, creating a V-shaped early recovery. However, when activity is near zero, any rebound looks dramatic. As you can see below, The Conference Board's Leading Economic Index plunged and rebounded. Although the latest monthly change (right chart) was substantial—and indeed, V-shaped—the current level (left chart) remains far below its pre-pandemic peak.

Trend versus level



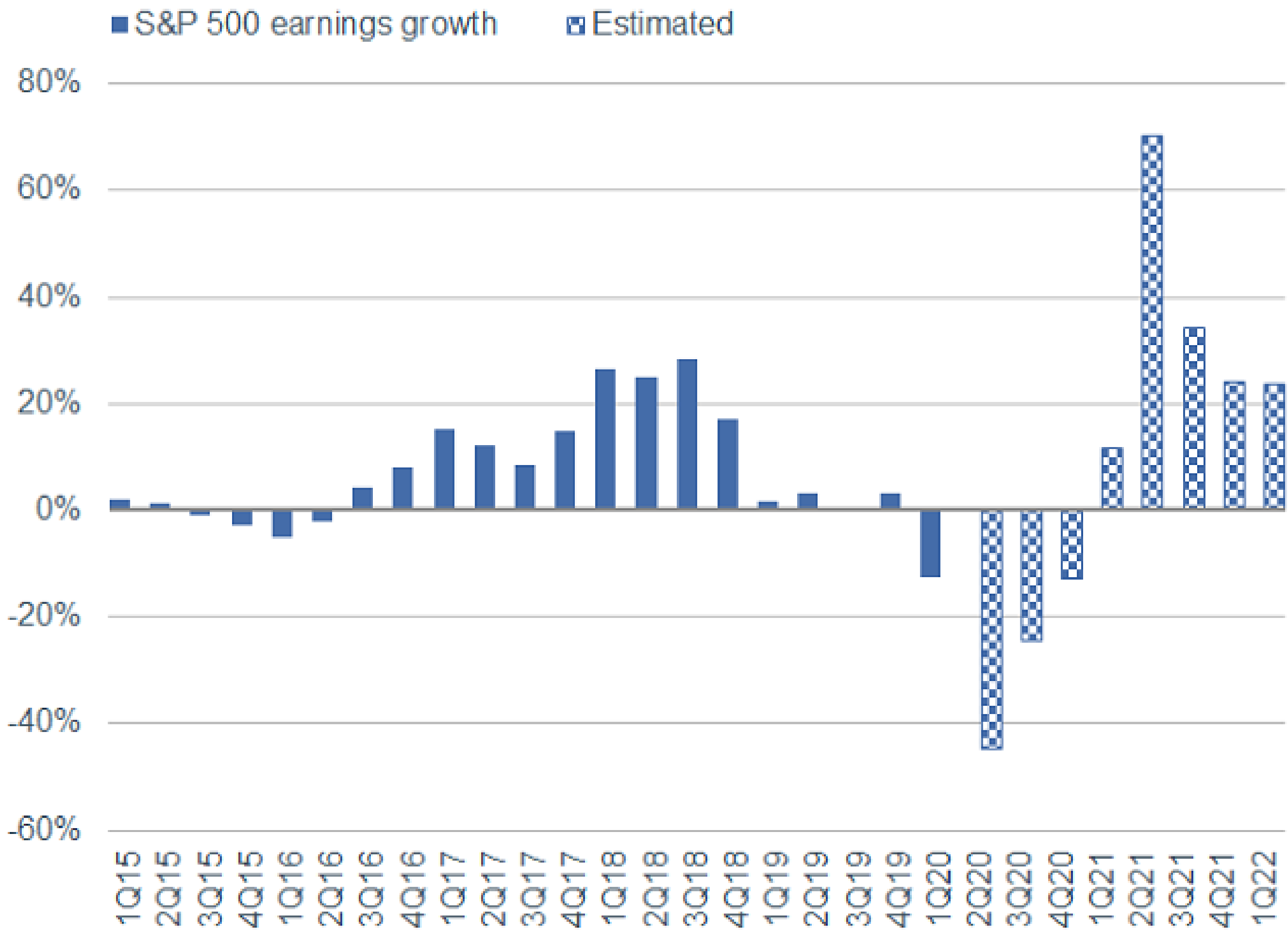
Source: Charles Schwab, Bloomberg, The Conference Board, as of 5/31/2020.

In normal environments, trends and rates of change tend to matter more than levels when comparing economic data and stock market behavior—but in today's world, level matters when trying to gauge how long it's going to take to recover the lost economic output.

Meanwhile, second-quarter earnings reporting season is starting. Analysts' consensus is for a sharp decline in profits—possibly more than -40%. However, the second quarter may already be baked into investors' psyches and stock prices. More important will be the forward-looking commentary from corporate executives, which could provide some clarity to an otherwise murky outlook.

You can see in the chart below that estimates are pointing to a sharp snapback in earnings growth in early 2021. However, note two things: Nearly 200 S&P 500 companies have withdrawn the guidance they traditionally provide to analysts, and the spread between analysts' lowest and highest estimates is historically wide. Again, any forward-looking guidance from companies likely will be the best indicator.

A sharp rebound in earnings is not guaranteed

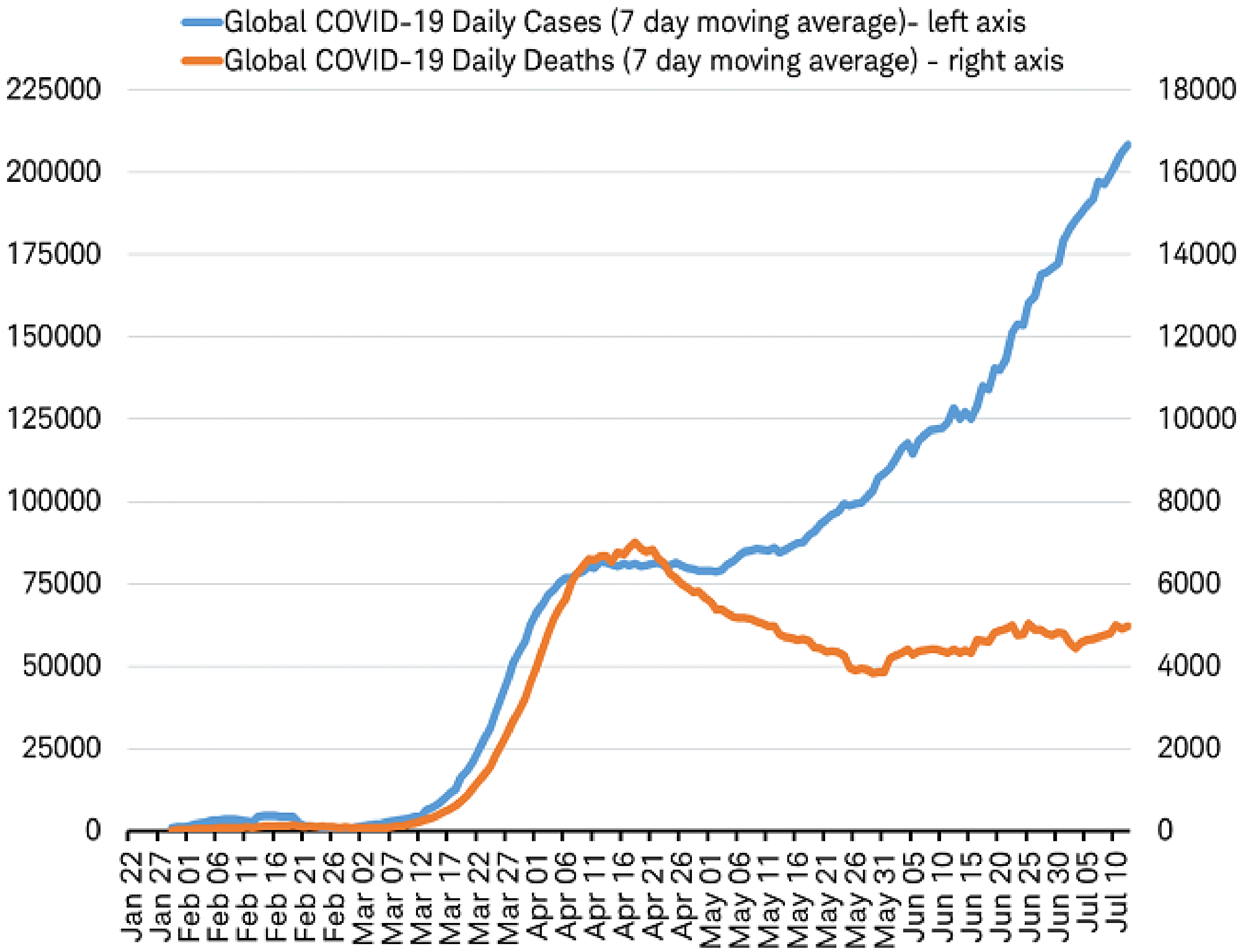


Source: Source: Charles Schwab, I/B/E/S data from Refinitiv, as of 7/15/2020.

Global stocks and economy: Could a "W" be a win for stocks?

We are not currently seeing signs of a return to recession in the global economy. The high-frequency weekly data we track on many major counties continues to reflect a V-shaped economic rebound—although we wouldn't be surprised to see some slowing from the early pace of recovery. Yet a "V" can merely be the start of a "W." The sharp rise in new COVID-19 cases in some countries could be followed by a rise in the daily number of new virus-related deaths and result in renewed, broad lockdowns across the global economy and a potential return to recession.

Renewed surge in cases not (yet) leading to surge in deaths

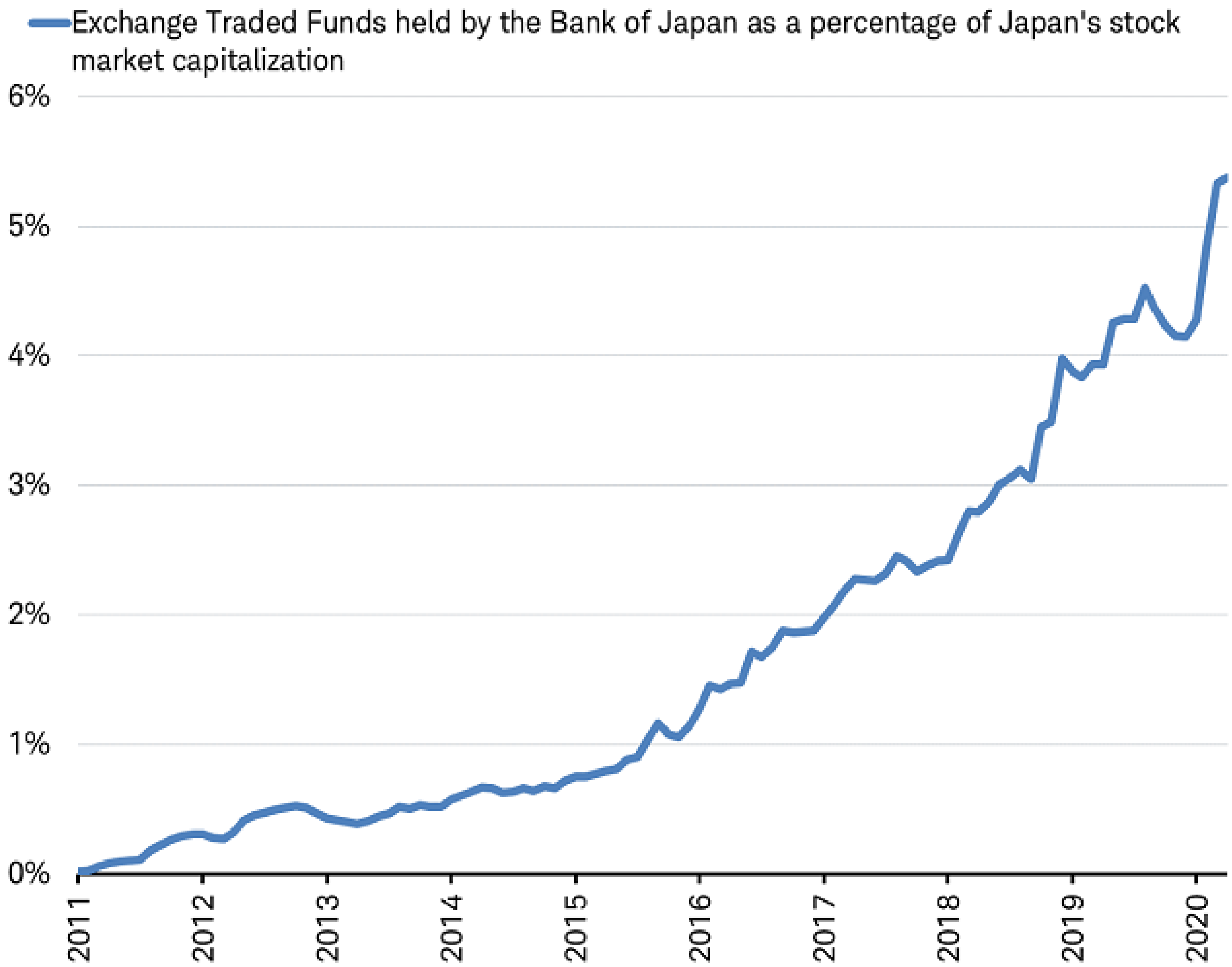


Source: Charles Schwab, Bloomberg data as of 7/13/2020.

Stocks have held onto their gains despite rising worries. Could this be in part due to investors believing that a W-shaped recovery could actually be a win for stocks? In the event of a "W," investors may anticipate that policymakers' worries about soaring bankruptcies may direct the government to take equity stakes in businesses.

Purchasing equity stakes in companies of all sizes—as an alternative to more loans to smaller businesses that may weigh on their ability to grow, or bailouts to a few large companies—is not a far-fetched idea. The Bank of Japan has been buying equity exchange-traded funds (ETFs) since 2010, and stepped up its purchases this year—they're now equivalent to more than 5% of Japan's stock market capitalization. China's government appears to have stepped in to buy stocks during periods of crisis (including this year), and the European emergency business loans made in the first round of the crisis have the option to be converted to equity. The equity investment idea seems to be gaining some traction with the Bank of England, the European Commission and finance leaders in Germany and France, as they discuss the merits of various proposals.

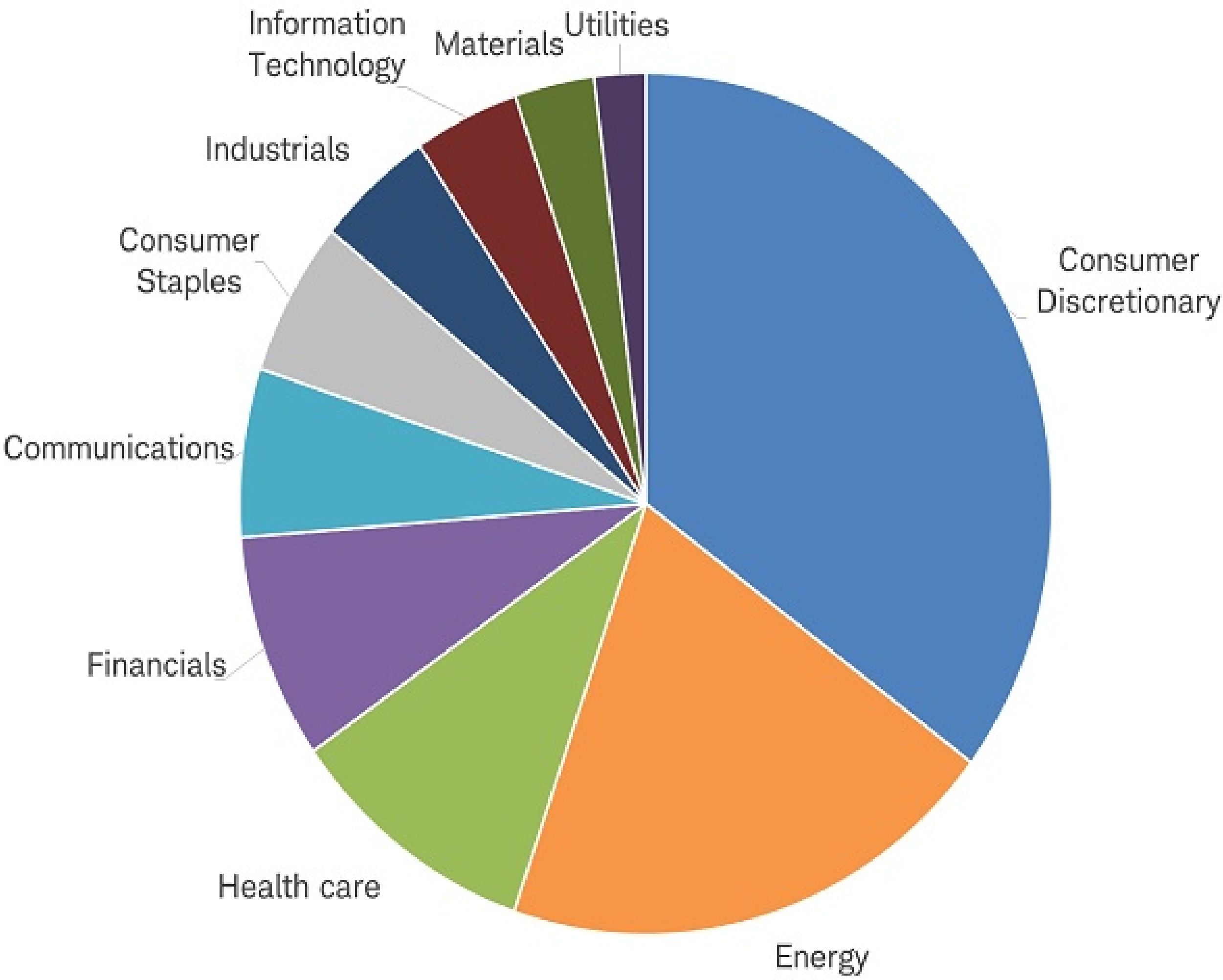
Rising ownership of equity ETFs by the Bank of Japan



*Market cap measured by Bloomberg Japan Exchange Market Capitalization Index.
Source: Charles Schwab, Bank of Japan, Bloomberg data as of 7/9/2020.

While governments' buying equities and bonds may not be enough to push stocks higher in the event of an economic "W," the potential for unlimited demand for stocks from governments could be a reason stocks have been resilient in the face of the recent rise in concerns. Despite its dominance in bankruptcy filings, Consumer Discretionary is the second-best-performing sector in global markets this year.

The Consumer Discretionary sector has led YTD bankruptcy filings

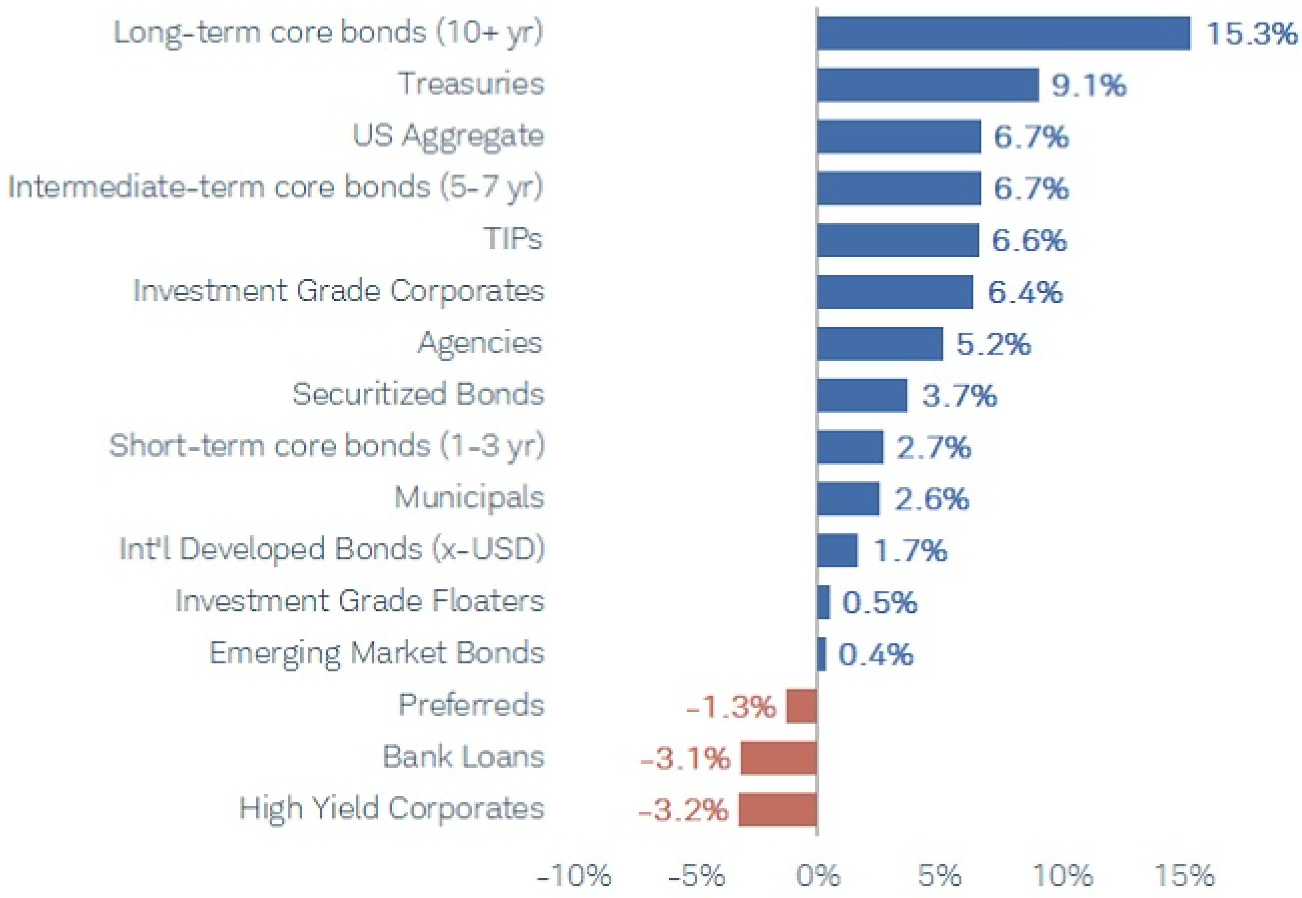


Calculated by the number of companies filing in each sector as recorded by Bloomberg.
Source: Charles Schwab, Bloomberg data as of 7/9/2020.

Fixed income: 2H returns to be driven by coupon income and fiscal policy

The first half of 2020 saw strong performance by the lowest-risk segments of the fixed income markets, such as long-term Treasuries and highly rated municipal and corporate bonds. Prices rallied in response to steep interest rate cuts by central banks and investor demand for safe haven assets, as the COVID-19 crisis spread globally. Higher-risk bonds, such as high-yield and emerging-market bonds, underperformed due to investor preferences for less risk and persistent uncertainty about the depth of the global recession.

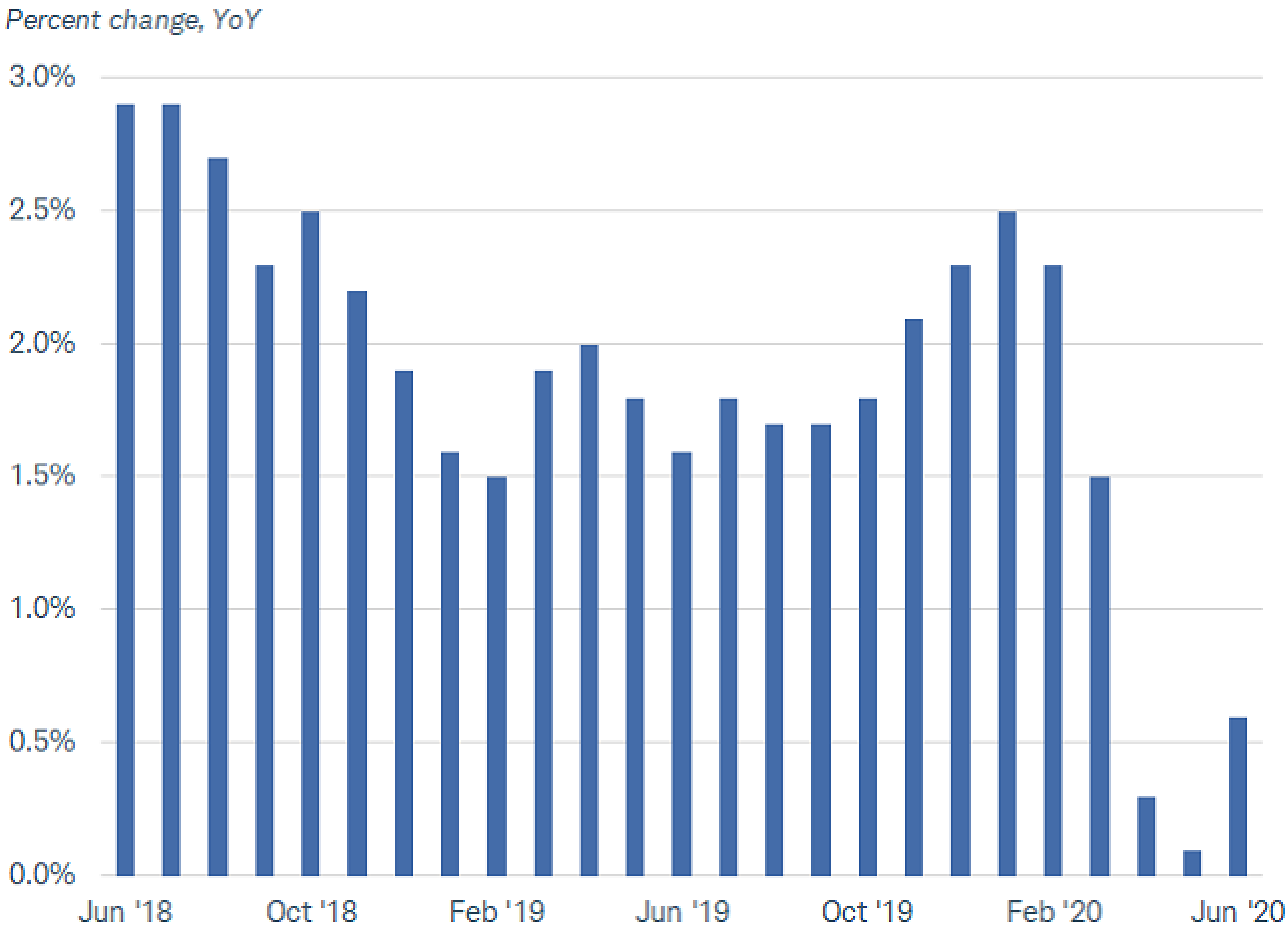
Fixed income asset class total returns, year-to-date



Source: Bloomberg. Returns from 12/31/2019 through 7/10/2020. Indexes representing the investment types are: US Aggregate = Bloomberg Barclays U.S. Aggregate Index; Short-term core = Bloomberg Barclays U.S. Aggregate 1-3 Years Bond Index; Intermediate-term core = Bloomberg Barclays U.S. Aggregate 5-7 Years Bond Index; Long-term core = Bloomberg Barclays U.S. Aggregate 10+ Years Bond Index; Treasuries = Bloomberg Barclays U.S. Treasury Index; Municipals = Bloomberg Barclays US Municipal Bond Index; Investment Grade Corporates = Bloomberg Barclays U.S. Corporate Bond Index; HY Corporates = Bloomberg Barclays US High Yield Very Liquid (VLI) Index; Preferreds = ICE BofA Merrill Lynch Fixed Rate Preferred Securities Index; Int'l Developed (x-USD) = Bloomberg Barclays Global Aggregate ex-USD Bond Index; Emerging Market USD = Bloomberg Barclays Emerging Markets USD Aggregate Bond Index; TIPS = Bloomberg Barclays U.S. Treasury Inflation-Protected Securities Index, Securitized = Bloomberg Barclays Securitized Bond Index, Floaters = Bloomberg Barclays U.S. Floating Rate Note Index, Bank Loans = The S&P/LSTA U.S. Leveraged Loan 100 Index. Returns assume reinvestment of interest and capital gains. 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.**

In the second half of the year, we expect the dynamic to change. Bonds yields are likely to remain low, but central bank policies probably won’t change much, now that policy rates are near zero in most major countries. The Federal Reserve has indicated it expects to hold the federal funds rate near zero for at least two years, and will continue to buy Treasuries for its balance sheet as long as it is not meeting its goals of full employment and inflation near 2%. Ten-year Treasury yields are likely to stay in a range between 0.5% and 1.0%, which leaves little room for price gains.

Falling inflation likely will keep bond yields low

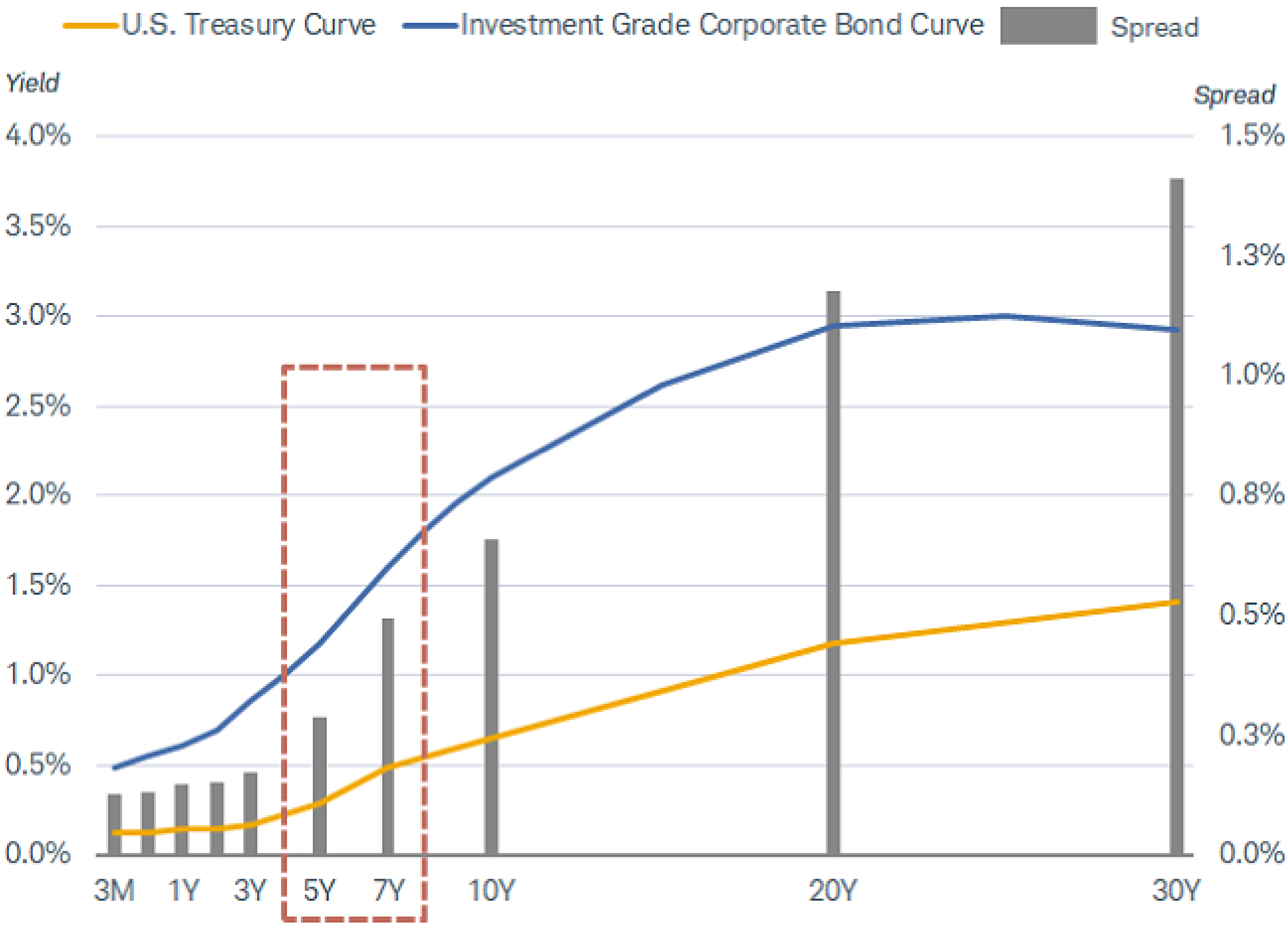


Notes: U.S. Consumer Price Index (CPI) measures changes in the price level of consumer goods and services purchased by households. Source: U.S. Consumer Price Index (CPI YOY Index). Monthly data as of 6/30/2020.

While monetary policy isn't likely to be as big a driver of returns, fiscal policy should be. Congress is currently debating the merits and terms of another fiscal relief package. In general, a further boost to economy from fiscal policy should help support consumption and employment, lifting expectations for a stronger recovery and providing support for bonds with more credit risk. The specifics of any package will be important for various segments of the market.

For the municipal bond market, direct grants to state and local governments would be especially positive, since municipalities have seen tax revenues drop and costs rise due to the coronavirus mitigation efforts. Further support for small- and medium-sized businesses could be supportive to the corporate bond market. Emerging-market bonds historically have benefited from policies that support global growth and lower volatility. Nonetheless, we believe investors should aim to stay in higher credit-quality bonds within all categories. Given the uncertainty regarding the economy's trajectory, we would avoid adding too much exposure to issuers with higher credit risk (that is, the risk that they'll default on their debt).

Intermediate-term investment-grade corporate bonds are relatively attractive



Source: Bloomberg, as of 7/10/2020. US Treasury Actives Curve and USD US Corporate IG BVAL Yield Curve (BVSC0076 Index). **Past performance is no guarantee of future results.**

With little room for yields on safe-haven bonds to fall, we believe performance in the fixed income markets is likely to be driven more by coupon income than price gains, which suggests holding a well-diversified portfolio that limits duration risk and has some exposure to highly-rated corporate and/or municipal bonds. For investors willing to take on more risk for more income, an allocation of up to 20% of an overall portfolio to preferred securities and/or emerging market bonds can make sense.

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