Schwab Market Perspective: Riding the Liquidity Wave

5/15/2020

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Some investors were surprised by U.S. stock market gains in April and early May, during a period of dismal economic news. Although the U.S. unemployment rate surged to 14.7% in April, a month in which 20.5 million jobs were lost, the S&P 500® index rose 13%. The index continued to gain ground in the first half of May.

Why is the gap between market and economic performance so wide? There are several reasons.

First, one of the more powerful forces driving markets has been the massive injection of liquidity from both the Federal Reserve and Congress. The Fed's balance sheet has grown exponentially, surpassing $6.7 trillion as of May 6, as the central bank bought securities in an effort to support prices and flood markets with cash. Meanwhile, Congress has reacted to the COVID-19 pandemic by doling out more than $2.5 trillion—in three separate phases—to taxpayers and businesses in the form of direct relief payments, loans and grants.

At the March lows, stocks were pricing in the kind of economic collapse we're currently in the midst of. However, the subsequent rally was less about economic optimism, and more about Fed-provided liquidity. Although stimulus can create its own set of problems over time, so far markets have been willing to focus on the positives and ignore any potential negative payback for the stimulus.

Second, while there is no comparable history to the current crisis, historically it has been common during recessions to see stocks rebound in advance of the trough in economic activity. In fact, the best forward one-year stock market returns historically have come after the worst decile of U.S. nonfarm payroll reports.

The best returns have followed the worst jobs reports

Source: Charles Schwab, Bloomberg, Bureau of Labor Statistics, 2/28/1939 to 4/30/2020. **Past performance is no guarantee of future results**.

It's worth noting, too, that the stock market's recent gains haven't been broad-based. Investors have piled into sectors that are generally well-insulated from coronavirus-related pressure, which have also attracted momentum-seeking investors. You can see in the following chart that these sectors—Information Technology, Communication Services and Health Care—now constitute over half of the S&P 500's market cap.

Three sectors now account for more than half of S&P 500 market cap

Source: Charles Schwab, Bloomberg, as of 5/14/2020.

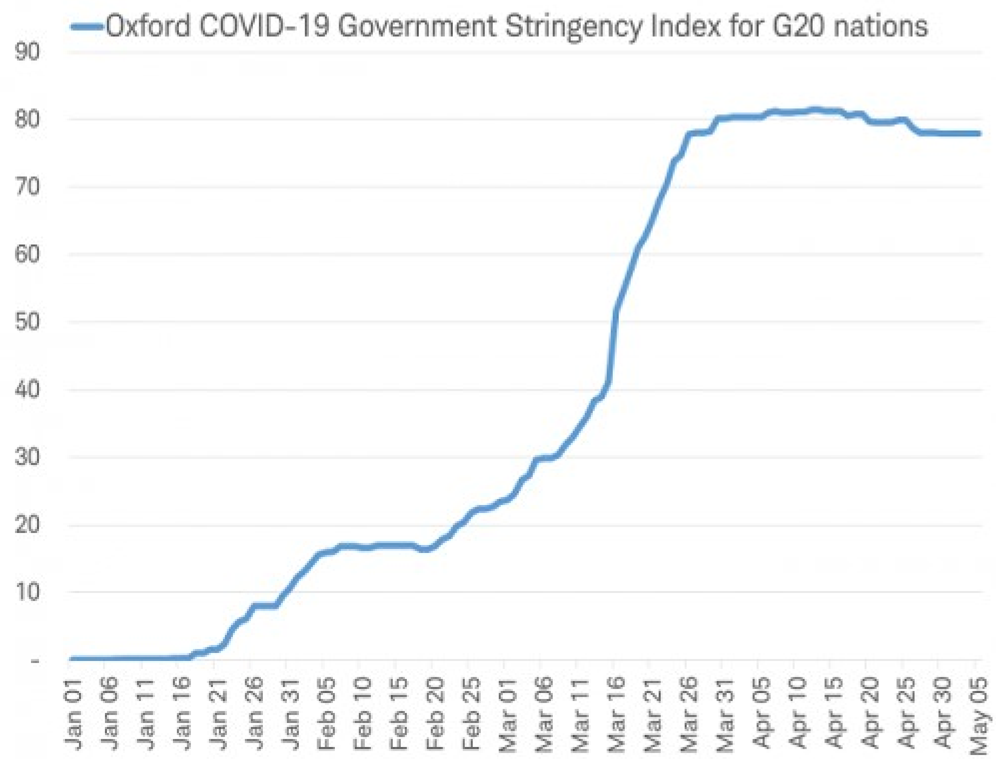
A relatively small number of stocks have been responsible for driving the rally. Large-cap stocks have continued to outperform vs. small caps, and the Energy sector has been the decisive leader since the S&P 500's recent low on March 23. Energy stocks' performance alone suggests that the recovery has been speculative in nature—representing more of a "reversion trade," rather than presumptive of an imminent rebound in economic growth.

We're past the peak in global lockdowns

As of last week, one could get a haircut in Germany, go to a bar in Spain, or back to school in Italy. As social restrictions are lifted, global economic data may begin to improve.

An Oxford University index measuring containment efforts peaked across the 20 major countries that make up the Group of 20 (G20) in mid-April and has now started to ease. We expect further easing in the coming weeks as countries implement their announced plans to loosen restrictions, and as life slowly begins to return to normal.

COVID-19 containment measures peaked in mid-April

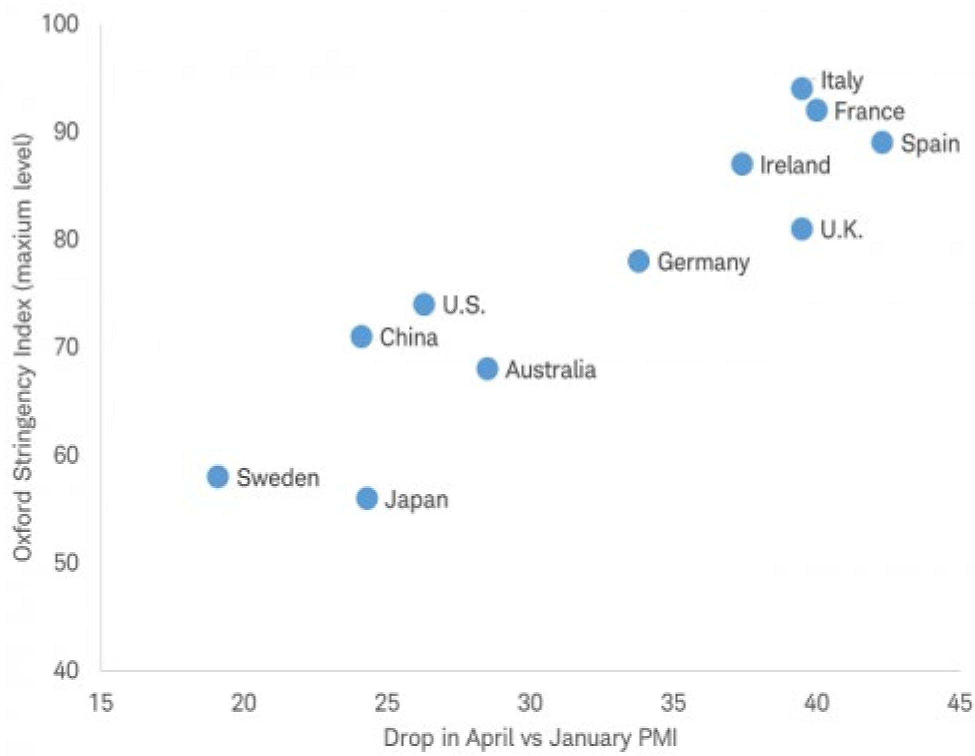


Note: Oxford University's COVID-19 Government Stringency Index uses 17 criteria to measure the stringency of national government responses to COVID-19. This list includes workplace, school and public transportation closings, cancellations of public events, restrictions on gathering size, shelter-in-place and home restriction orders, restrictions on internal movement or international travel, and public information campaigns.

Source: Charles Schwab, Oxford University Blavatnik School of Government as of 5/7/2020.

There are significant differences in the severity of lockdown restrictions among the world's governments. Countries with the most stringent restriction measures saw bigger negative impacts on their economies. For example, stricter measures coincided with sharper declines in composite purchasing manager indexes (PMIs).

The more stringent the lockdown, the bigger the economic hit



Source: Charles Schwab & Co, Oxford University, Bloomberg, as of 5/8/2020. China's figure uses the drop in February versus January to reflect the differing timing of lockdowns.

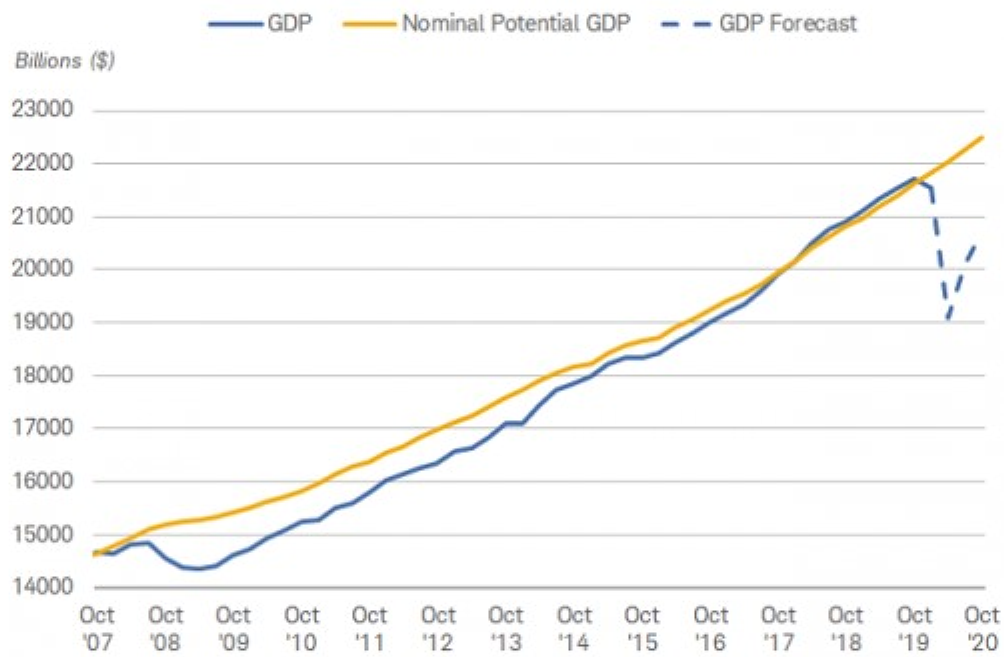
There are also differences in the rate at which countries are easing restrictions. Will countries easing at a faster pace have a more rapid economic recovery? It's possible, although the pace of recovery may rely more on the comfort levels of businesses to open and of consumers to leave their homes.

Bonds, bonds everywhere

In the second quarter, the U.S. Treasury will auction a record $3 trillion in debt to finance the widening federal budget deficit. With tax revenues declining and government spending rising in response to the COVID-19 crisis, the markets are bracing for a continued deluge of bonds this year. The supply will be more heavily weighted to longer-term maturities than in the past. The Treasury is even introducing a 20-year bond issue.

With the prospect of increasing supply on the horizon, can yields stay low? Although increased issuance can push up yields, especially long-term bond yields, we believe expectations about growth and inflation have a greater influence on yields than supply. Currently, the depth of the current downturn has opened up a wide gap between the economy's potential growth rate and its actual growth. We expect relatively low interest rates to prevail until there are signs of stronger economic growth on the horizon.

GDP is running below potential, suggesting inflation is not a near-term threat



Source: U.S. Bureau of Economic Analysis and U.S. Congressional Budget Office. Nominal Potential Gross Domestic Product (NGDPPOT), Gross Domestic Product, and the Gross Domestic Product Forecast. Quarterly data as of Q1 2020 with forecast through Q4 2020. Nominal GDP measures a country's economic growth using current prices, without adjusting for inflation; whereas real GDP adjusts for inflation.

Federal Reserve policy is also likely to keep yields low. With the federal funds policy rate set near zero and the Fed buying bonds (expanding its balance sheet), we don't see a lot of room for yields to move higher over the next year or so. The Fed has already increased its balance sheet by over $1.2 trillion in the past few months. The pace of Fed bond buying has slowed recently as markets have stabilized, but we do expect to see more purchases, and the balance sheet could grow to as much as $10 trillion over the next year or two. That will absorb a lot of supply. There has also been demand from foreign central banks and institutional investors to buy Treasuries for safety, liquidity, and a relatively high yield compared to other major government bonds.

The Federal Reserve's balance sheet has risen by more than $1 trillion since mid-March

Source: All Federal Reserve Banks: Total Assets, Trillions of Dollars, seasonally adjusted. Weekly data as of 5/6/2020.

Nonetheless, the bond market is facing an unusual set of circumstances. The risks to our low-yield forecast are that the economy may begin to improve, or there could be a loss of confidence in the management of the debt—if those things happened, yields could move up more rapidly than we anticipate.

We are watching the dollar as a key indicator. A stronger outlook for global growth would weaken demand for the dollar and U.S. Treasuries' safe-haven attractiveness, reducing the demand for dollars. If markets lose confidence in the United States' ability or willingness to finance its debts, then it's likely that the dollar would fall as foreign investors shift to local markets.

What You Can Do Next

- Read more about Schwab's perspective on recent market volatility.
- **Schwab clients, please reach out** if you'd like discuss your portfolio. Contact your Schwab Financial Consultant or call us at 800-355-2162.
- **If you're not a client**, learn how Schwab can help you reach your goals.

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Kathy Jones heads up the Fixed Income and Currency strategy group at the Schwab Center for Financial Research, where she is responsible for Schwab's point of view on the markets and investor education. 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.