SCHWAB CENTER FOR FINANCIAL RESEARCH

Investing & Markets Outlook

July 2021

INVESTING OUTLOOK

Tactical Investing Ideas

More Attractive	Less Attractive
International developed large company stocks: A new economic cycle could bring new leadership by international stocks due to better expected growth, lower valuations, and higher exposure to cyclical sectors (see slide 7).	**U.S. large cap equities:** U.S. stocks could underperform on a relative basis as a new economic cycle could bring new leadership by international stocks due to better expected growth, lower valuations, and higher exposure to cyclical sectors.

Sector Views

Outperform	Underperform
Health Care: Favorable valuations, post-COVID-19 return of elective care, and a robust pharma development pipeline are augmented by strong balance sheets and increasing health care demand—together potentially offsetting the defensive nature of the sector in a rising market. Drug price controls would be a risk.	**Utilities:** A renewed rise in interest rates and continued advance in the overall market are headwinds to this interest-rate-sensitive, defensive sector. Relative to other sectors, fundamentals and momentum are weak. However, a bigger-than-expected, utility-related infrastructure package would amplify investment. **Consumer Staples:** With higher confidence in a sustained economic recovery, this traditionally defensive sector is more likely to underperform. Companies will have limited pricing power if recent surge in inflation proves to be transitory—but vice versa.

Investing involves risk, including loss of principal.

SCFR Investing & Markets Outlook

SCHWAB CENTER FOR FINANCIAL RESEARCH

In this publication, the Schwab Center for Financial Research provides its point of view on timely issues of importance to investors as they make decisions about their portfolios. The perspectives in this report are current as of July 1, 2021.

This report covers six key areas:

- Macro Outlook
- U.S. Equities
- U.S. Fixed Income
- International Equities
- International Fixed Income
- Washington

MACRO OUTLOOK

Growth has improved with vaccines, but upside to estimates may be limited

- **Growth estimates have improved with vaccine progress, but the virus and higher prices could limit further gains.** The on again/off again restrictions to keep the Delta variant from spreading are creating concerns about further upside to estimates, particularly in countries with lower vaccination rates. However, supply chain bottlenecks and some commodity prices have eased, which could improve the future outlook. A premature tightening of financial conditions remains a risk.

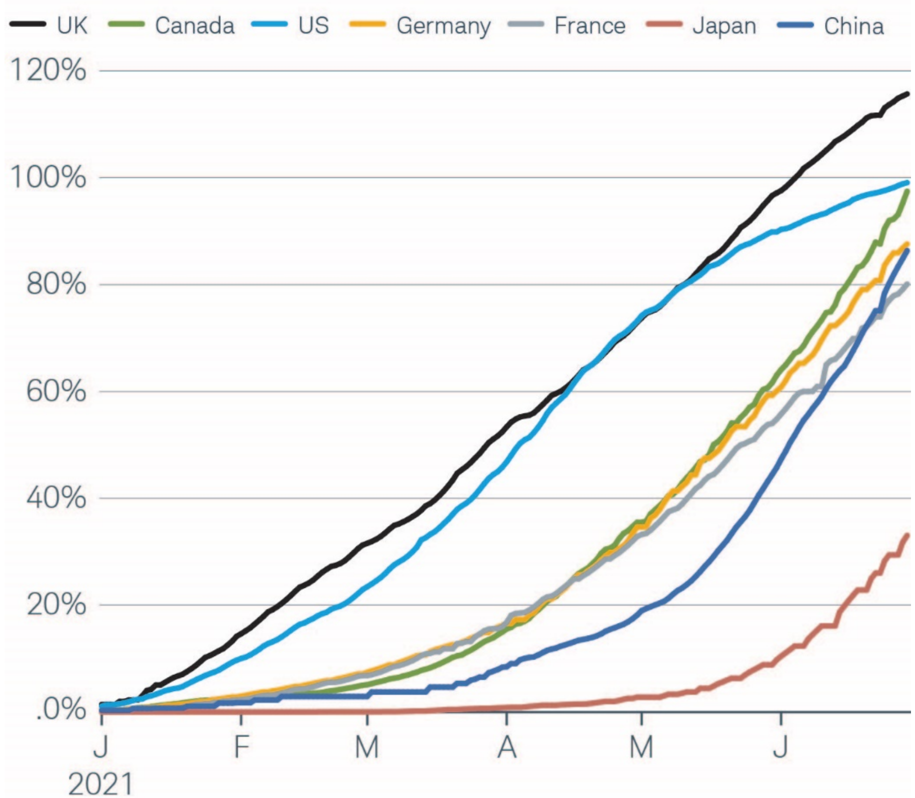
- **Growth rates have likely peaked**. Growth estimates remain strong, with most economists estimating double-digit percentage GDP growth in the second quarter. Yet, given that direct fiscal aid has wound down and monetary stimulus is easing, several economic metrics are likely approaching a peak in the growth rate. This doesn't suggest growth itself is peaking, but, rather, as the economy normalizes after record-breaking stimulus, a cooling is inevitable.

- **Supply and price pressures fading**. Inflation remains a major concern as metrics like the consumer price index (CPI) continue to grow at their fastest pace since 2008. Yet, some stress is starting to ease as commodity prices, notably, lumber, have rolled over and survey-based data confirm that companies are starting to see lower prices for input and raw materials.

Vaccine progress has accelerated in larger countries

Less-developed countries are still struggling for doses

*Total doses administered as a % of total population**



Source: Charles Schwab, Bloomberg, as of 6/29/2021. *Most vaccines require two doses to be fully vaccinated.

U.S. EQUITIES

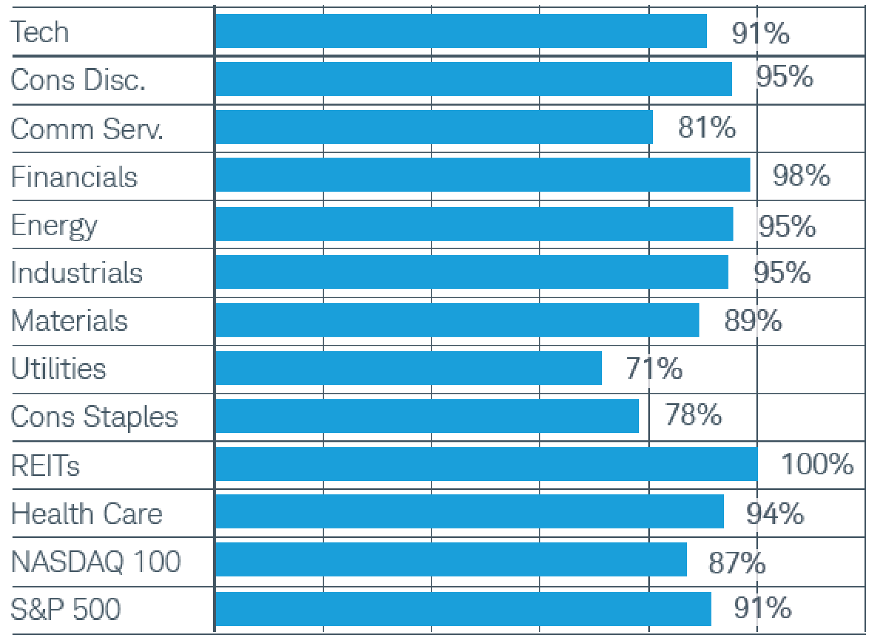
Stocks are climbing, with sector leadership still mixed

- **U.S. stock indexes have trended modestly higher, with cyclical areas lagging.** The growth-oriented sectors—and those considered defensive last year—such as Technology and Consumer Discretionary have accelerated over the past month as rates have continued to move sideways. This has yet to dent the longer-term performance of traditional cyclicals like Energy and Financials, and notably, several value factors (different from the indexes) continue to outperform in nearly every sector.
- **Short-term breadth is deteriorating**. Fewer than 50% of S&P 500 members are trading above their 50-day moving average, a substantial decline from 92% in mid-April. Fortunately, that has yet to bleed into longer-term breadth, as more than 90% of members are still trading above their 200-day moving average (with cyclicals quite strong). Should the latter start to weaken, the broader market's ascent may stumble.
- **Elevated sentiment**. While most sentiment metrics do not reflect extreme optimism, they are still elevated, making equities increasingly vulnerable to negative catalysts.
- **A broad rotation underway favors neutral positioning**. An expectation of stronger growth outside of the U.S. this year bodes well for developed international equities, which underscores our tactical overweight to developed-market large caps relative to large-cap U.S. equities.

Broad sector participation

More than 90% of S&P 500 members are above their 200-day moving average, with cyclical areas exhibiting strength

Percent of S&P 500 members above 200-day moving average



Source: Charles Schwab, Bloomberg, as of 6/29/2021.

Past performance is no guarantee of future results.

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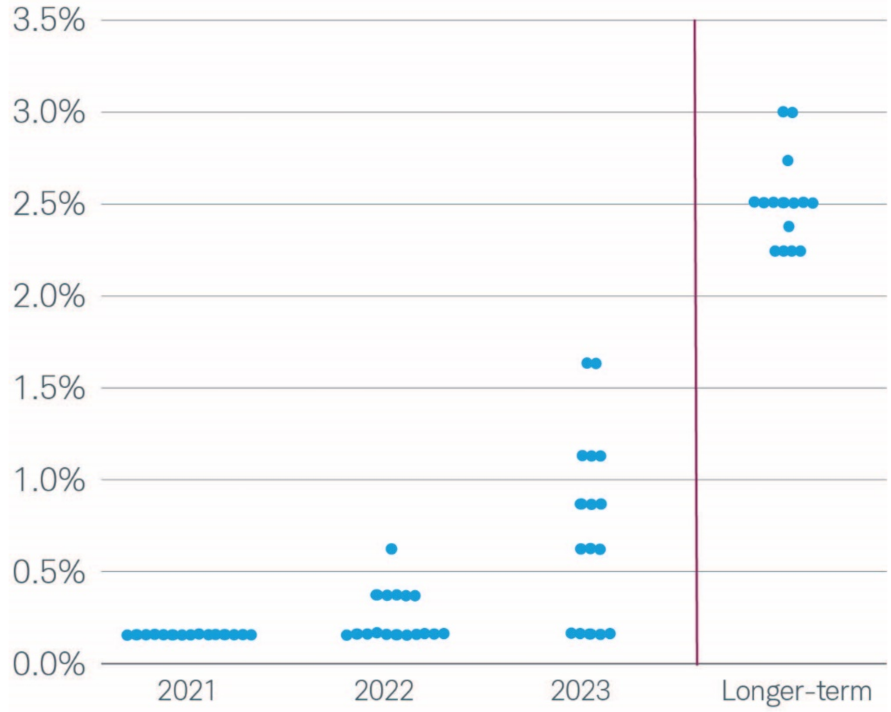
U.S. FIXED INCOME

Fed projections indicate sooner-than-expected rate hikes

- **Rate hike projections have been pulled forward to 2023.** The updated Federal Open Market Committee (FOMC) projections now point to two rate hikes by the end of 2023, and almost half of the FOMC members project a rate hike in 2022.
- **Fed tapering is on deck.** The Fed needs to end its bond-buying program before it starts hiking rates. The Fed's bond buying is a form of easing, while rate hikes tighten financial conditions, so it is inconsistent do both simultaneously. The tapering announcement should come this fall.
- **The 10-year Treasury yields should still rise to 2%.** After peaking at 1.75% in March, the 10-year yields have been trending lower ever since as the market recalibrated its growth and inflation expectations. While we believe yields might be rangebound during the summer, they should continue to rise as the year progresses, given the strong growth outlook.
- **Suggest a below-benchmark average duration** given our outlook for higher long-term yields. If the 10-year Treasury yield rises as expected, investors should then consider adding some intermediate-term bonds.
- **Look for high-yielding opportunities—cautiously.** Relative yields for most fixed income investments remain very low, but the strong economic backdrop supports the case to hold higher-yielding investments in moderation.

First rate hike is now projected in 2023

Thirteen of the 18 FOMC members project at least one rate hike by 2023



Source: Bloomberg. FOMC Dot Plot as of 6/16/2021.

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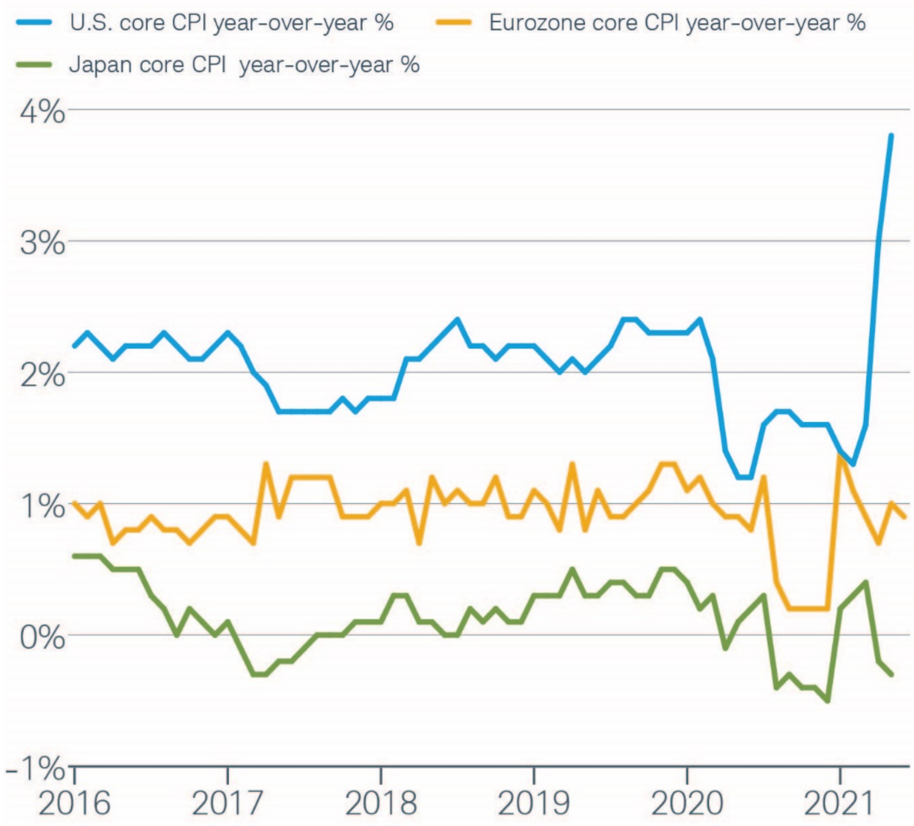
INTERNATIONAL EQUITIES

International stocks may outperform in the long term

- **International earnings growth is expected to outpace the U.S. in 2021**, which could prompt a long-term shift toward international stocks outperforming U.S. stocks. Cyclical stocks—such as international developed-market (DM) and emerging-market (EM) stocks—typically do well when global growth accelerates.
- **Europe and Japan likely to tighten policy later than the U.S.** Good news on better growth in the U.S. may prompt the Fed to tighten policy sooner, which markets perceive as negative. In contrast, inflation hasn't risen much in Europe and Japan, and policy rates aren't as negative on a real basis, so any tightening cycle is likely to be more gradual. Good news could still propel international stocks higher.
- **We believe emerging-market stocks may rebound and rise alongside interest rates**, because both tend to climb as global growth improves. With less access to COVID-19 vaccines, EM countries could struggle with continued virus waves.
- **Tactical investing idea:** A new economic cycle could bring new leadership by international stocks due to better expected growth, lower valuations, and higher exposure to cyclical sectors. U.S. stocks could underperform, relatively speaking.

The rise in inflation has not been global

Core prices–excluding food and energy–more subdued overseas



Source: Charles Schwab, Bloomberg data as of 6/18/2021. CPI = consumer price index.

INTERNATIONAL FIXED INCOME

Hawkish Fed could keep the dollar strong

- **The dollar strengthened on Fed rate hike projections.** The U.S. dollar reversed its downward trend as the Fed's rate hike projections were pulled forward to 2023. Rising interest rate differentials could keep the dollar strong going forward.
- **A strong dollar can weigh on international bond returns.** With yields so low, currency movements can have an outsized impact on the total returns of local currency-denominated bonds. Low or negative yields on international bonds means there's not much income generated to help offset those potential losses.
- **International bond yields remain low.** The average yield-to-worst of the Bloomberg Barclays Global Aggregate ex-USD Index is just 0.8% and there is still more than $13 trillion in negative-yielding debt across the globe.
- **Emerging market bonds: neutral allocation.** We previously suggested investors overweight EM bonds, as their relative yields appeared attractive, and the weaker dollar supports emerging market economies. However, EM bond spreads have declined, valuations no longer appear very attractive, and dollar strength can be a headwind. If long-term Treasury yields rise as we expect, that can pull EM bond yields up (and prices down), dampening their potential total returns.

The dollar has risen from the 2021 lows

Rising interest rate differentials can lead to a stronger dollar

Bloomberg Dollar Spot Index

Source: Bloomberg, using daily data as of 6/30/2021. Bloomberg Dollar Spot Index (BBDXY Index).

WASHINGTON

Congress continues to wrangle over infrastructure and tax hikes

- **Key weeks ahead for turning bipartisan infrastructure deal into actual legislation.** The White House and a bipartisan group of 21 senators have agreed to the outlines of a $1.2 trillion "roads, bridges, and broadband" deal. But it still needs to be turned into actual legislation. The goal is to pass the deal by the end of July, but that may be overly ambitious.
- **Meanwhile, Democrats will focus on drafting a second economic bill that is likely to include tax increases.** All 50 Senate Democrats would need to agree—and that won't be easy, given the ideological divisions within that group. Increasing the corporate rate and the top individual tax rate seem likely; changes to capital gains taxes and estate taxes are far less certain. Stay tuned—July will be a key month to determine whether Democrats can unite on a plan.
- **Securities and Exchange Commission (SEC) chair outlines aggressive regulatory agenda.** SEC Chair Gary Gensler, in a series of speeches, put forward a daunting list of priorities for the remainder of 2021, including new climate risk disclosures for public companies, toughening rules for special-purpose acquisition companies (SPACs), and an overhaul of equity market structure, among others. All of these could have huge implications for ordinary investors. But the regulatory process is very slow, so these are longer-term initiatives that investors should keep an eye on.

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