

Schwab Market Perspective: Earnings Verdict? Recovery on Track

by Liz Ann Sonders, Chief Investment Strategist, Charles Schwab & Co, Inc. and
Brad Sorensen, CFA, Director, CFA, Director of Market and Sector Analysis, Schwab
Center for Financial Research
October 30, 2009

Earnings season is largely complete and helped confirm the recovery taking hold. There will be bumps along the way but we don't believe investors should sit on the sidelines.

- *Market gains might be more muted in coming months and pullbacks are likely, but we still believe the general trend is higher, with occasional bumps along the way.*
- *Earnings season was not the blowout a few had been hoping for, but it largely confirmed that the environment is improving, with the majority of companies "cautiously optimistic."*
- *The Chinese economy continues to lead the world recovery, but divergences are emerging. Still, we firmly believe that investors who haven't done so need to have at least some exposure to international markets.*

Skeptics continue to question the staying power of the stock market rally that we've seen since the March lows, with major indexes up over 50%, and keep pointing to the need for a major pullback after such a run.

Of course, it's the same tune we've been hearing since the first 20% of the move, and those who've attempted to "time" the market have likely been left behind.

In fact, we're in the midst of a seasonal period that's usually been strong for the market and tough for those steadfast bears, with both November and December typically posting higher-than-average gains.

We remain relatively optimistic on the market's prospects while certainly acknowledging that a pullback would not be surprising and a repeat of the previous six months' performance is highly unlikely.

We hasten to remind investors attempting to time their entry into the market that they risk missing out on possible gains (and likely some sleep, as well), and urge investors still on the sidelines to bring their equity allocations up to a risk tolerance-appropriate level.

Higher expectations the bar for third-quarter reports

The bar for third-quarter earnings reports was set a bit higher than for the previous two quarters, as investors are now looking for revenue growth, as opposed to just cost-cutting.

As a result, we've seen more muted reaction to "earnings above estimates," of which we've seen many, with more than 80% of companies in the S&P 500 beating estimates as of October 23, according to Bespoke Investment Group (B.I.G.).

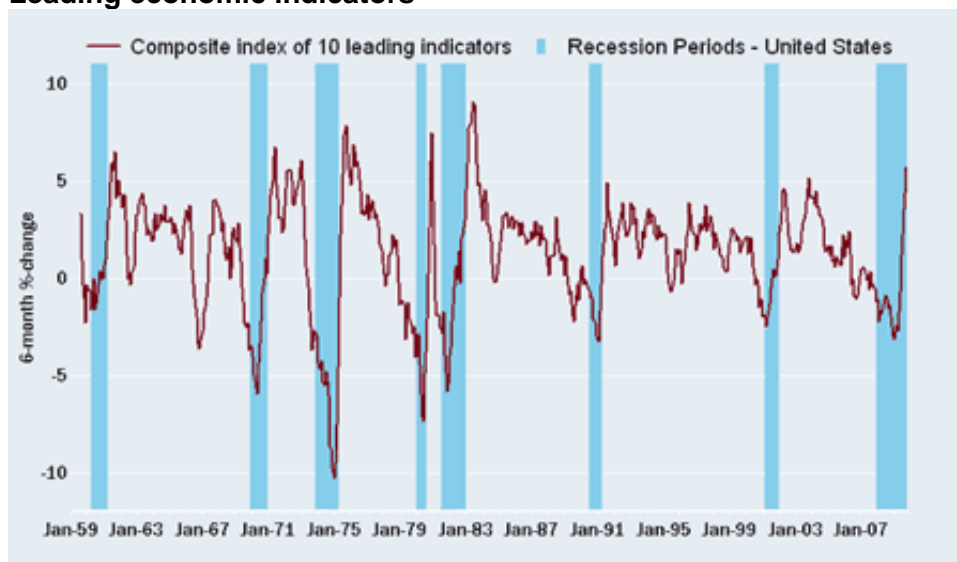
Revenues have been a bit more mixed, resulting in a relatively flat market performance through the reporting period. However, commentary coming from the majority of reporting companies has been better than in previous quarters.

Many executives believe the worst is behind us and that they're seeing signs (although tenuous in some cases) of improvement in 2010. As we've been saying, we believe this confirms what much of the economic data has been showing—that the recovery seems to be gaining some steam.

Recovery continues (with some bumps along the way)

Recent economic data has also largely confirmed that the economy is recovering, with the Index of Leading Economic Indicators beating estimates and rising by 1% in September—the sixth straight month of gains—while the six-month growth rate improved to the highest pace since 1983.

Leading economic indicators



Source: FactSet, US Conference Board as of October 28, 2009.

Additionally, despite media refrains of a "jobless recovery," we're seeing signs that employment is improving. The four-week moving average of jobless claims continues to fall, temporary employment (which tends to lead overall employment) is moving higher, and the employment subcomponents of many regional surveys are also showing marked improvement.

While we haven't seen positive job growth on the nonfarm payroll front yet, losses are moderating, and, given the lagging nature of the report, we expect to see some positive job additions by early 2010, especially given improved corporate profitability.

Not all data has been rosy, as some of the recently released housing numbers have been a bit disappointing. Both housing starts and building permits declined in the most recent reports, although existing home sales were better than expected, illustrating what we've believed for some time—that the housing recovery will not be a smooth process.

Housing remains one key to recovery and there are likely to be more disappointing numbers as the much-discussed "shadow inventory" puts more supply in the market.

Additionally, questions are swirling as to whether mortgage rates can stay low as the Federal Reserve ends its purchases of mortgage-backed securities (MBS), and how much the possible expiration of the \$8,000 first-time-buyer housing credit will affect the nascent recovery.

Mortgage rates



Source: FactSet, Freddie Mac as of October 28, 2009.

Removing the training wheels?

The aforementioned issues are part of the larger story of when the economic recovery is going to become self-sustaining.

We are seeing some pullback in the extraordinary monetary and fiscal stimulus measures put in place at the height of the financial crisis, with the Fed ending its asset purchase programs, and the federal government (at least for the time being) letting such measures as the "cash-for-clunkers" program and the first-time-homebuyer credit expire—although there continues to be talk of extending the latter.

How the market reacts to these modest pullbacks will be key to the future viability of the recovery. We believe that programs like the two mentioned above simply pull demand forward a bit, but do little to stimulate overall sustainable economic activity, and we hope that the government allows markets to regain equilibrium rather than try to just "kick the can" down the road.

We remain concerned with the level of actual and proposed government spending and are watching developments in Washington closely, as overreaching on both the spending and regulatory fronts could result in renewed pressure on the economy.

As for the Fed, it faces the delicate task of removing its unprecedented stimulus in a way that forestalls any potential inflationary threat, while not doing so in a way that would crush the economic recovery. The Fed has already started to do so by letting its Treasury and MBS purchase programs expire in the near future.

Of course, the major question continuing to surround the central bank is when it is going to raise interest rates. With *Barron's* cover recently "urging" Fed Chairman Ben Bernanke to raise rates now (which we think is highly unlikely), the debate has escalated.

We believe that the Fed will indeed raise rates sooner than many believe—perhaps as soon as the first quarter of 2010—but want to remind investors concerned about such an action that rates are currently at emergency levels of near 0%. Worse news would be if the economy justified 0% interest rates too far into the future.

It's difficult to argue that we're still in a financial emergency, and even a series of moves that left rates around 2% would still represent an extremely low level when viewed in a historical context.

Global economic plunge and recovery in tandem, outlooks becoming differentiated

An interconnected global economy and the severity of decline in economic activity affected countries around the globe. Economies have improved in 2009, but the recovery has not been felt equally due to country-specific factors.

One is the importance of exports and the level of reliance on two countries in particular, China and the United States. The United States comprised nearly 30% of global consumption before the crisis and is retreating, while China is the fastest-growing major economy, now the third-largest in terms of gross domestic product (GDP).

China's growth in 2009 remains relatively unfettered:

- Third-quarter GDP growth of 8.9% year-over-year (y/y).
- Industrial production up 13.9% y/y in the third quarter.
- Retail sales up 15.5% y/y in September.
- New bank loans grew 26% month-over-month and 38% y/y in September while money supply (M2) grew 29% y/y.

Stimulus likely waning in countries where growth is strongest

Aided by China's booming demand for commodities, Australia became the first G-20 nation to raise rates, and the central bank indicated that growth would likely be close to trend over the year ahead and inflation close to target.

GDP grew every quarter during the crisis and is expected to grow 2.9% in 2010, with consumer price index (CPI) growth of 2.4%.

Brazil has also benefitted from Chinese commodity demand, returning to positive GDP growth of 7.9% GDP in the second quarter. The growth story in Brazil has not gone unnoticed, and rapid flows of money into the country have buoyed the local currency, the real.

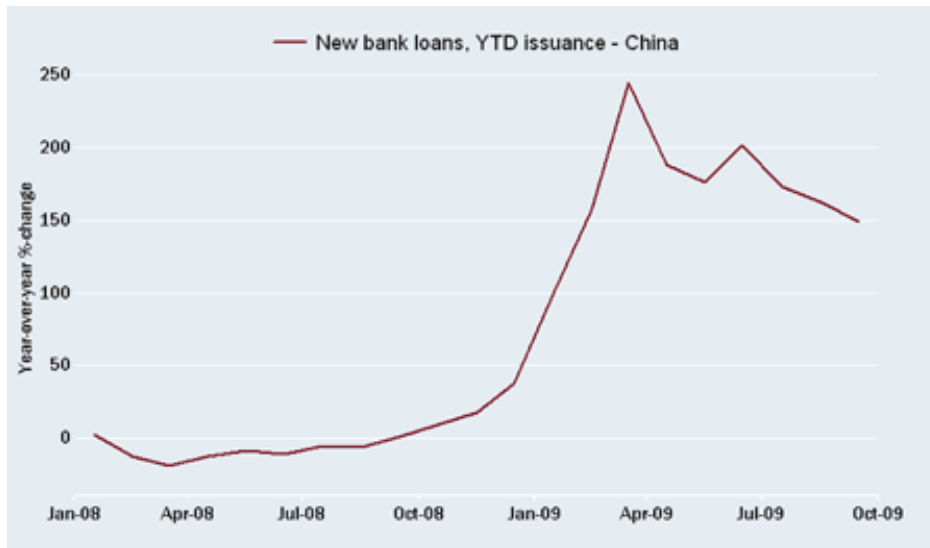
The Brazilian government announced a 2% tax on purchases of fixed-income securities and equities by foreigners, seeking to curb the strength in the real due to concerns about speculative investments, and the negative impact a rising currency has on exports.

While India's economy has few ties to China, as exports account for only 15% of GDP, it is often viewed in a similar bucket as China, due to its large population and strong economic growth potential. GDP has grown roughly 6% in 2009.

India's central bank took its first step toward tightening monetary policy by making a surprise move to require banks to set aside more reserves, seeking to restrain liquidity that could threaten inflation.

Moves to rein in growth by these countries increase scrutiny of China's policies in light of outsized growth in GDP and lending.

Government-driven infrastructure spending drove the majority of Chinese growth in 2009. With weak exports and excess factory capacity, the government faces the challenge of providing enough job growth outside of stimulus measures. As a result, Chinese officials have maintained adherence to moderately easy monetary policy.



Source: Source: FactSet, Bloomberg as of October 28, 2009.

However, risks are increasing. China's State Council said on the eve of the GDP release: "the policy focus of the next few months is to balance the need to maintain stable and relatively fast growth, the need to adjust the economic structure and the need to better manage inflationary expectations."

Unlike the United States, rising money supply in China has translated into strong loan growth, increasing the risk of inflation. Additionally, food is the biggest component of CPI, at 34%, and rising commodity prices threaten consumer spending.

We believe the Chinese government will continue to pursue growth strategies to avoid rising unemployment. Stimulus measures in 2010 will likely be smaller, but exports can start to contribute to GDP in 2010 with a return of global growth.

Barriers to growth remain in other economies

Meanwhile, Canada's natural resource strength has not translated into GDP growth, as the nation remains more dependent on the United States than China, with nearly 75% of exports shipped to the United States.

Canada's central bank is concerned about local currency strength: "Heightened volatility and persistent strength in the Canadian dollar are working to slow growth and subdue inflation pressures."

Elsewhere, European economies are also diverging, with the United Kingdom unexpectedly posting a 0.4% decline in third-quarter GDP, marking the sixth-straight negative quarter, versus the expectation of 0.1% growth.

The United Kingdom is trailing growth in France and Germany, which have experienced auto manufacturing rebounds related to incentives, and better retail sales due to healthier consumer balance sheets. Additionally, Norway's central bank raised rates in response to robust growth aided by commodity strength and fiscal stimulus.

Hurdles for growth in the United Kingdom include rising taxes and spending cuts necessitated by large fiscal and trade deficits and corresponding rising government debt, which resulted in a credit outlook downgrade in June.

Additionally, its economy is highly dependent on finance and banking, and the resultant deleveraging by individuals and businesses will weigh on growth.

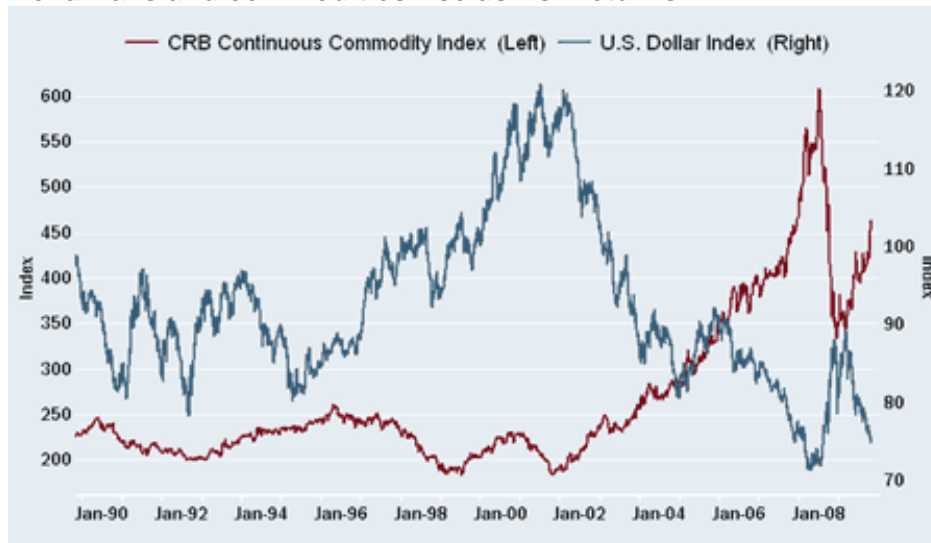
While Australia is pausing, the United Kingdom may need to step up stimulus—we will be monitoring the November 5 meeting of the Bank of England for any changes to its asset purchase program.

What are the implications for international allocations?

We attribute dollar weakness to rising risk appetites, as investors sell the US dollar to fund riskier investments. We don't subscribe to the view of a dollar crash, only a mean reversal to the downward trend in place before the credit crisis.

The dollar's long-term outlook is hampered by fiscal and trade deficits, resulting in rising debt. But investments that play on dollar weakness are "crowded trades," and countertrend rallies in the dollar are likely.

Dollar falls and commodities rise as risk returns



Source: FactSet, Commodity Research Bureau, New York Board of Trade as of October 28, 2009.

We believe portfolios should include an international allocation, as lower correlations can improve the overall risk-return profile, and in light of a longer-term downward trend in the dollar. However, these markets are likely to pullback after strong performance in 2009 with any rise in the dollar.

Factors that could provide a short-term countertrend lift to the dollar include intervention by foreign governments to weaken their currencies and any change in expectations for Fed policy that would imply a sooner-than-expected rate hike in response to a stronger economic recovery.

However, in order for intervention to make permanent change, central banks would have to purchase large amounts and convince markets they are willing to intervene without limit, such as the People's Bank of China has done with the yuan to maintain a dollar peg.

Important Disclosures

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