2017 Schwab Market Outlook

Schwab’s team of market experts share their perspectives and provide investment guidance.
Times are changing. The second half of 2016 marked a sea change in market expectations. Around the globe in 2017, monetary policy will likely give way to fiscal policy as a driver of economic growth. Deflation fears are giving way to inflation fears. As world governments respond to a rise in populism, the long-term trend of increasing globalism and expanding free trade may be at risk and government budget deficits are likely to grow.

» In the U.S., S&P 500 earnings are expected to grow by more than 12% in 2017. Earnings and economic momentum are picking up.

» Stock market valuations are reasonable considering today’s low inflation. A higher rate of inflation, however, could lower stock valuations.

» International stocks are likely to underperform U.S. stocks due to changes in relative growth momentum and political risk, especially in Europe.

» Bond yields are rising and the yield curve is steepening on expectations of stronger growth and inflation. These trends are likely to continue in early 2017.

» Tighter monetary policy and greater fiscal spending, along with potential trade tariffs, are likely to lead to another year of a strong U.S. dollar.
‘Animal Spirits’ Rising

With consumer, business and investor confidence rising, it appears that “animal spirits” are awakening after a long slumber. Animal spirits is meant to describe the human emotion that drives confidence and, in turn, action.

Economic data have improved alongside the prospect of a business-friendly Trump administration, helping to bolster both stock prices and Treasury yields.

Potential regulatory and tax reform, including corporate tax cuts—possibly to as low as 15% from the current 27% effective tax rate—have led to a surge in analysts’ expectations for S&P 500 earnings.

Solid job and income growth, consumer spending and housing are positives for the U.S. economy. Rising business optimism, however, needs to translate into more capital spending.

A stronger dollar is a risk as it could weigh on exporters, but it would also keep inflation in check.

Business Optimism Is Surging

A rise in business optimism likely reflects pro-business policy proposals of the Trump administration, including tax and regulatory reform.

Duke University/CFO Magazine Business Outlook Survey - economy optimism level


Liz Ann Sonders @LizAnnSonders

U.S. domestic mutual fund flows have been mostly negative since 2008, suggesting a lot of money could yet flow in.

Domestic equity mutual fund flows (in billions of dollars)

‘Animal Spirits’ Rising

**KEY POINTS**

» U.S. stocks have been building on post-election gains, with cyclical stocks rallying, suggesting growing investor confidence in the strength of the economy.

» Good seasonality, improving earnings growth and stronger U.S. equity fund flows should keep the bull market alive in 2017.

» Earnings are expected to grow by double digits in 2017, thanks to the rebound in the energy sector and the increased likelihood of tax and regulatory reform.

» As long as inflation does not accelerate sharply, stock market valuations appear reasonable.

» After such a strong year-end rally, bouts of volatility and market pullbacks should be expected in 2017.

**INVESTOR TAKEAWAY**

» The outlook for relative economic growth and risk favors U.S. stocks over developed market international stocks.

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**Inflation Isn’t Likely to Hurt P/E Ratios**

Forward price-to-earnings ratios are reasonable vs. the historic average when core CPI inflation was around 2% to 3%. Unless the inflation rate rises sharply, downward pressure on P/Es should be minimal.

<table>
<thead>
<tr>
<th>Inflation</th>
<th>Average P/E</th>
<th>Highest P/E</th>
<th>Lowest P/E</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-1%</td>
<td>16.3</td>
<td>20.9</td>
<td>11.7</td>
</tr>
<tr>
<td>1-2%</td>
<td>17.0</td>
<td>20.6</td>
<td>13.1</td>
</tr>
<tr>
<td>2-3%</td>
<td>17.6</td>
<td>26.7</td>
<td>10.8</td>
</tr>
<tr>
<td>3-4%</td>
<td>16.0</td>
<td>20.7</td>
<td>10.1</td>
</tr>
<tr>
<td>4-5%</td>
<td>14.0</td>
<td>21.0</td>
<td>9.5</td>
</tr>
<tr>
<td>5-6%</td>
<td>14.9</td>
<td>20.2</td>
<td>8.2</td>
</tr>
<tr>
<td>6-7%</td>
<td>11.6</td>
<td>17.9</td>
<td>7.2</td>
</tr>
<tr>
<td>&gt;7%</td>
<td>8.4</td>
<td>11.5</td>
<td>6.6</td>
</tr>
</tbody>
</table>

Source: Bureau of Labor Statistics, FactSet, as of November 30, 2016. Inflation is y/y % change based on core CPI.

**Liz Ann Sonders @LizAnnSonders**

Negative earnings growth has ended and expected earnings growth is accelerating sharply, due in part to a recovery in the energy sector.

**S&P 500 operating earnings growth (yearly percentage change)**

Unlike a year ago, the global economy is accelerating, driven primarily by better growth in the United States and emerging markets.

The return of inflation in 2017 may help to lift sales for global companies, bolstering business leaders’ confidence and spending.

Despite rising fears of protectionism, world trade may surprise naysayers with 3% to 4% growth, reversing the slowdown in 2015 and 2016 – although not returning to the boom years of the early 2000s.

**Revenues May Rise in 2017**

Nominal GDP growth may exceed 5% in 2017 for the first time in six years, helping the sales of global companies to grow for the first time since 2012.

![World Nominal GDP in current US dollars with IMF forecast for 2016 and 2017](chart)

*IMF forecast from the October 2016 World Economic Outlook

Source: Charles Schwab, International Monetary Fund and FactSet data as of November 18, 2016.

**World trade volume of goods and services annual growth rate**

- 1981: Reagan’s first year in office
- 2017 IMF forecast: Trump’s first year in office

Source: Charles Schwab, International Monetary Fund data as of December 2, 2016
There was a global wave of populist political outcomes in 2016, including the Brexit vote, the U.S. election and the Italian referendum. Stocks slid ahead of those votes, only to rally on the results. Markets may follow a similar pattern leading up to 2017 elections in France (April/May) and Germany (September/October).

Even with the focus shifting from monetary to fiscal policy makers in 2017, central bankers in Europe and Japan are still likely to pursue aggressive short-term stimulus measures, raising the risk of longer term imbalances.

Bank of Japan Risks Being Biggest Owner of Stocks

The BOJ is on track to become the largest stockholder in close to half of Japanese stocks as it continues to pursue its aggressive stimulus program in 2017.

Sources: Charles Schwab & Co., Inc., Bank of Japan, Bloomberg, Goldman Sachs, as of December 7, 2016. Weights in 2017 assume the BOJ continues to purchase at the 5.7 trillion yen pace that excludes physical and human capital related ETFs, and that current shareholders don’t make changes to their holdings.

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Anti-establishment political outcomes in 2017 may bring market volatility. Brexit vote in June 2016 led to a spike in UK political risk.

Source: Bloomberg data as of December 1, 2016
Fixed Income

Short Term Pain, Long Term Gain?

KEY POINTS

» We expect the Fed to increase short-term interest rates at least twice in 2017 as growth and inflation pick up. To mitigate the impact of higher rates, we would limit average bond portfolio duration to the short to intermediate term.

» Treasury Inflation-Protected Securities (TIPS) should outperform nominal Treasury bonds as inflation expectations rise.

» U.S. dollar strength should continue on the back of higher U.S. interest rates relative to other countries. We suggest underweighting international bonds.

» Longer term, tighter monetary policy and a strong dollar should limit inflation and the rise in bond yields.

» Investors should look for opportunities to add income to portfolios later in the year as interest rates move up. We expect the 10-year Treasury yield to trade in the 2.5% to 3% range in 2017.

TIPS Breakeven Rates Look Attractive

With the breakeven rate on 10-year TIPS below the consensus forecast for 2017 inflation, we believe they are attractive relative to nominal Treasuries.

10-Year Breakeven Rate

Consensus Forecast: 2017 CPI

Note: Breakeven inflation is the difference between the nominal yield on a fixed-rate investment and the real yield (fixed spread) on an inflation-linked investment of similar maturity and credit quality.

Source: Bloomberg, monthly rates as of December 20, 2016. Bloomberg consensus forecast represents the consensus forecast for the year-over-year change in the Consumer Price Index for all Urban Consumers (CPI-U).

Source: Bloomberg Barclays Global Aggregate ex-US Bond Index

The strong dollar continued to weigh on foreign bond returns

*Currency Return may include paydown return

Credit Is Relatively Expensive

**KEY POINTS**

» Expansive fiscal policies and tax reform should help boost corporate earnings, while more stable commodity prices may reduce the risk of price volatility of the high-yield corporate bond market.

» Corporate bond valuations are not attractive, however. The yield advantage that both investment grade and high-yield corporate bonds offer relative to U.S. Treasuries is well below their historical long-term averages.

» Investment-grade floating-rate bonds appear attractive as their coupons should continue to benefit from more Fed rate increases, and their prices tend to be stable.

**Corporate Valuations Are Not Attractive**

Credit spreads have declined for both investment grade and high-yield corporate bonds, meaning investors aren’t getting much additional yield relative to U.S. Treasuries.

**INVESTOR TAKEAWAY**

» Wait for a better entry point in corporate bonds to increase your holdings above your strategic, long-term allocation, and consider floating-rate notes for short-term investments.
Muni Bonds Absorb News of Reform

Yields Have Responded Post-Election
The sharp rise in Treasury and muni yields since November suggests the market is anticipating fiscal stimulus in 2017.

<table>
<thead>
<tr>
<th>Year</th>
<th>MMA AAA Muni GO 10-Year Yield</th>
<th>U.S. Treasury 10-Year Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>1%</td>
<td>2%</td>
</tr>
<tr>
<td>2011</td>
<td>2%</td>
<td>3%</td>
</tr>
<tr>
<td>2012</td>
<td>3%</td>
<td>4%</td>
</tr>
<tr>
<td>2013</td>
<td>4%</td>
<td>5%</td>
</tr>
<tr>
<td>2014</td>
<td>5%</td>
<td>6%</td>
</tr>
<tr>
<td>2015</td>
<td>6%</td>
<td>7%</td>
</tr>
<tr>
<td>2016</td>
<td>7%</td>
<td>8%</td>
</tr>
</tbody>
</table>


INVESTOR TAKEAWAY
» Tax-exempt income remains attractive for many investors. Higher yields after taxes, even if taxes fall, and periods where yields rise above Treasuries can provide attractive entry points for investors in 2017.

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At federal tax rates above 8%, municipal bonds yield more after taxes than Treasuries and corporates.

<table>
<thead>
<tr>
<th>Bond Credit Rating</th>
<th>Municipal Bond yield (%)</th>
<th>Treasury Bond yield (%)</th>
<th>Corporate Bond yield (%)</th>
<th>Federal tax rate required to make Treasury or corporate yield equal to municipal yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>2.5%</td>
<td>2.4%</td>
<td>-</td>
<td>N/A</td>
</tr>
<tr>
<td>AA</td>
<td>2.9%</td>
<td>-</td>
<td>3.3%</td>
<td>7.5%</td>
</tr>
<tr>
<td>A</td>
<td>3.1%</td>
<td>-</td>
<td>3.4%</td>
<td>1.7%</td>
</tr>
<tr>
<td>BBB</td>
<td>4.7%</td>
<td>-</td>
<td>4.0%</td>
<td>N/A</td>
</tr>
</tbody>
</table>

Note: The "after-tax" yield for corporate and Treasury bonds is found by calculating the yield on corporate or Treasury bonds times (1 – the tax rates). Corporate bonds assume an additional 5% state tax rate.
Source: Bloomberg, as of December 1, 2016. Yields are for 10-year maturities.
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Fixed income securities are subject to increased loss of principal during periods of rising interest rates. Fixed-income investments are subject to various other risks including changes in credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications and other factors.

While the market value of a floating rate note is relatively insensitive to changes in interest rates, the income received is highly dependent upon the level of the reference rate over the life of the investment. Total return may be less than anticipated if future interest rate expectations are not met.

International investments involve additional risks, which include differences in financial accounting standards, currency fluctuations, geopolitical risk, foreign taxes and regulations, and the potential for illiquid markets. Investing in emerging markets may accentuate these risks.

Tax-exempt bonds are not necessarily a suitable investment for all persons. Information related to a security’s tax-exempt status (federal and in-state) is obtained from third-parties and Schwab does not guarantee its accuracy. Tax-exempt income may be subject to the Alternative Minimum Tax (AMT). Capital appreciation from bond funds and discounted bonds may be subject to state or local taxes. Capital gains are not exempt from federal income tax.

High-yield bonds and lower rated securities are subject to greater credit risk, default risk, and liquidity risk.

Treasury Inflation Protected Securities (TIPS) are inflation-linked securities issued by the US Government whose principal value is adjusted periodically in accordance with the rise and fall in the inflation rate. Thus, the interest amount payable is also impacted by variations in the inflation rate as it is based upon the principal value of the bond. It may fluctuate up or down. Repayment at maturity is guaranteed by the US Government and may be adjusted for inflation to become the greater of either the original face amount at issuance or that face amount plus an adjustment for inflation.

Index and Term Definitions

S&P 500® Index is a capitalization-weighted index of 500 stocks from a broad range of industries. The component stocks are weighted according to the total market value of their outstanding shares.

The MSCI All Country World Index (ACWI) captures large and mid-cap representation across 23 Developed Markets (DM) and 23 Emerging Markets (EM) countries. With 2,484 constituents, the index covers approximately 85% of the global investable equity opportunity set.

The Nikkei-225 Stock Average is a price-weighted average of 225 top-rated Japanese companies listed in the First Section of the Tokyo Stock Exchange.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

The Bloomberg Barclays U.S. Corporate Bond Index covers the U.S. dollar (USD)-denominated investment-grade, fixed-rate, taxable corporate bond market. Securities are included if rated investment-grade (Baa3/BBB+/BBB-) or higher using the middle rating of Moody’s, S&P and Fitch ratings services. This index is part of the Bloomberg Barclays U.S. Aggregate Bond Index (Agg). The Bloomberg Barclays U.S. Corporate 1-5 Year Bond Index is part of the Barclays U.S. Corporate Bond Index.

The Bloomberg Barclays U.S. Corporate High-Yield Bond Index covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody’s, Fitch, and S&P is Ba1/BB+/BB+ or below.

The Bloomberg Barclays U.S. Floating-Rate Notes Index measures the performance of investment-grade floating-rate notes across corporate and government-related sectors.

Barclays Global Aggregate Bond Index provides a broad-based measure of the global investment-grade fixed-rate debt markets. The three major components of this index are the U.S. Aggregate, the Pan-European Aggregate, and the Asian-Pacific Aggregate Indices. The Global Aggregate Bond Index ex US excludes the U.S. Aggregate component.

Barclays U.S. Corporate High-Yield Bond Index covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody’s, Fitch, and S&P is Ba1/BB+/BB+ or below.
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