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Quarterly Commentary

Liz Ann Sonders, Schwab's insightful chief investment officer, prefers to think about the economy in terms of "better or worse" instead of "good or bad." In other words, expectations can be more important than actual results for investors. So, while the latest corporate earnings were "good," they were "worse" than expected. And while economic fundamentals were "good", they were worse than previously strong levels.

We think Sonders' insight explains the stock market's sell-off in Q4. Dashed expectations more than "bad" news shook investor confidence, leading to an oversold market. Investors were already jittery, and easily spooked by any sign that the bull market had finally ended. One sign was market volatility, which returned with a vengeance in Q4. Put part of the blame on algorithmic trading programs. These momentum-driven, computer-executed trades have little connection to underlying fundamentals, but their effects have an outsized impact. The tightening of liquidity also unnerved investors. Unrelenting downside volatility further tends to shake out less confident investors. It may take time, but we expect investor confidence will be restored as the U.S. economy continues to show good results.

We aren't ignoring red flags. Three fundamental drivers pose concern – a weak Europe, exacerbated by the Brexit debacle, protectionism led by the US, and a too-restrictive central bank monetary policy, also led by the US. These self-inflicted government policies do not inspire investor confidence; however, we believe each can be reversed or improved. Neither the Fed nor the President wants to be blamed for the next recession; and we don't foresee one without a major policy blunder.

Other one-off items are wreaking havoc on confidence: the flattening yield curve; Trump & his Cabinet; Congress (potential reversal of tax policies & impeachment); Chinese & Russian hacking; corporate misbehavior (Facebook, Huawei, Carlos Ghosn); the Middle East and the slumping price of oil; high sovereign debt levels and rising fiscal deficits; etc. And the list goes on.

Despite all these confidence-sapping headwinds, the actual operating environment for businesses remains reasonably good, with 2019 earnings expected to grow by 5%-10%. Once investors feel reassured that these positive business trends are sustainable, we expect them to re-enter the market and push values back towards levels that reflect underlying fundamentals.

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