2023 Global Market Outlook

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Following 2022, a year with the fewest positive trading days for stocks in more than a decade (see figure 1), we believe a better but still bouncy year for investors may lie ahead. Volatility is likely to remain high as 2023 gets underway. Central banks are shifting tactics. A global recession is rolling across sectors of the global economy. China is ending zero COVID. These factors and more may contribute to lingering uncertainty in the global markets over the direction of the economy and inflation and drive elevated volatility. The result is a “bunny” market—one that’s hopping up and down. We believe that 2023 likely will continue the trend established during the past year. Investors can continue to focus on stocks with the specific qualities that outperformed in the up-and-down markets of 2022. Despite the strong dollar, international markets outperformed in 2022 for the first time in many years and may continue to do so in 2023.

SHIFTING TACTICS

Overall, markets looked to be taking direction from central banks during 2022, and we anticipate that will probably continue this year. Tighter monetary policy, largely in the form of aggressive rate hikes, characterized much of 2022 and provided a headwind to stock markets. Although a pivot to rate cuts does not seem likely in the near term, we’ve already seen a reduction in the size of rate hikes and in some cases even a pause, which may bolster markets in 2023:

- The U.S. Federal Reserve slowed its pace of rate hikes to 50 basis points (bps) in December from 75 bps at each of the prior four meetings.
- The Bank of Canada stepped down from 75 bps to 50 bps in late October.
- The central banks of Australia and Norway moved down from 50 bps to 25 bps at meetings in October and November.
- The central bank of one of the largest emerging market economies, Brazil, and the central bank for the largest emerging market economy in Europe, Poland, both paused, leaving rates unchanged.

With the first indications of central banks’ easing the size of rate hikes, the MSCI World Index of global stocks rallied more than 15 percent in the fourth quarter of 2022, the strongest gain for a quarter since the pandemic rebound in the second quarter of 2020.

Figure 2 shows the pace of rate hikes for major central banks.

The pace of rate hikes is not the only strategy shift we’re seeing from central banks. In mid-December 2022, the Bank of Japan made an unexpected and surprising change in its Yield Curve Control policy. The policy rate remained at -0.10 percent and the target for the Japanese 10-year government bond (JGB) yield is still 0.0 percent, but the Bank of Japan announced a widening of the trading range of the 10-year JGB, from ±25 bps to ±50 bps, and stepped up its monthly bond purchases to 9 trillion yen per month for Q1 2023, an increase from 7.3 trillion yen. Bank of Japan Governor Haruhiko Kuroda stated that the move was to improve market functioning, but this may be an indication that even Japan is starting to normalize monetary policy from its easy stance and may indicate the first of more moves to raise rates in Japan and bring the era of negative global policy rates to a close.

Markets may have priced in an expectation that central banks are nearing the end of the rate-hiking cycle. For now, major central bankers are making it clear that they are not quite finished, despite
having reduced the size of the rate hikes. The current focus, especially in the United States, is on the labor market, which tends to lag changes in the economic cycle. The labor market is essential to taming inflation and may drive central banks to take rates too high and overshoot their response—and deepen the economic downturn.

**BREWING RECESSION**
Inflation still is stubbornly high worldwide. Central banks’ stepping down the pace of rate hikes is more about responding to weak economies than making strong progress on lowering inflation. Global growth in advanced economies, according to International Monetary Fund (IMF) forecasts, slowed from 5.2 percent in 2021 to 2.4 percent in 2022 and is predicted at just 1.1 percent for 2023. Although not officially declared, we see evidence that a global recession likely began sometime during the third quarter of 2022.

Historically, an inversion of the U.S. Treasury yield curve tends to signal a global recession. There are about 90 different U.S. Treasury yield spreads when comparing every shorter maturity to longer active maturities. Rather than picking just one yield spread, such as the 10-year to 2-year, looking at all the spreads tells us how much of the whole curve is inverted. Since early August 2022, more than 50 percent of the U.S. Treasury yield curve had inverted (see figure 3).

The composite leading indicators for the world economy produced by the Organisation for Economic Co-operation and Development (OECD) dropped below 99 during the second half of 2022, also signaling another potential recessionary period (see figure 4). A drop in this index below 99 tends to happen right around the start of a global recession, as can be seen at early 2020, early 2008, early 2001, late 1990, late 1981,
mid-1974, and mid-1970. We even saw this indicator give a double-dip below 99 before recovering after the recessions in the early 1990s and early 2000s.

Additionally, the global Purchasing Managers’ Index (PMI) also signaled recession, having slipped below 50—the threshold between expansion and contraction—during the third quarter of 2022 (see figure 5).

Fortunately, the depth of this potential recession appears to be mild so far. Some parts of the global economy and some countries are growing, offsetting others that are contracting. For example, although there remains strength in services, as seen in travel and leisure, the demand for and manufacture of goods has been weakening, as evidenced by rising inventories and slowing product sales. The likely recession is rolling through different parts of the global economy at different times, in contrast to the recessions of 2008–09 and 2020, which were everything and everywhere all at once.

A risk to the base case of a mild recession also was a major factor in the last recession: housing. In 2022, mortgage rates rose sharply in many countries. Households without long-term fixed-rate financing face steep increases in monthly mortgage payments as interest rates reset higher over the next 12 months, risking a shock to consumer spending across major countries. Combining data on the share of households with mortgages and mortgage structures, we estimate a significantly greater risk of mortgage shocks in the United Kingdom, Norway, and New Zealand, and some risk in Australia, Sweden, and Canada, compared with the United States, France, Germany, and Italy (see figure 6).

Markets seem to believe robust credit quality is likely to avert a mortgage shock this time around. Although the details vary by country, stricter leverage requirements since the Global Financial

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**Figure 4**

GLOBAL LEADING INDICATORS POINT TO RECESSION


**Figure 5**

GLOBAL PMI SLIPPED INTO RECESSION TERRITORY IN Q3 2022


**Figure 6**

RISK OF MORTGAGE SHOCKS GREATER IN UNITED KINGDOM, NORWAY, AND NEW ZEALAND

Crisis, interest-rate stress tests at origination, and mortgage insurance requirements for high-risk borrowers have contributed to significant increases in credit quality. However, should any potential global recession linger, any increase in unemployment coupled with higher rates may raise the pressure on homeowners, reinforcing a negative feedback loop and deepening a recession.

**ENDING ZERO COVID**

At a large economic cost to the world’s second-largest economy, China has had more success containing the spread of COVID-19 compared to other countries. October’s 2022 estimates by the IMF show its economy grew at only 3.2 percent for 2022, compared to 8.1 percent in 2021. This outcome was mainly attributed to the zero-COVID policy, which included stringent lockdowns in local communities until no new cases of the virus were identified. Amid multiple waves of COVID-19 outbreaks and subsequent restrictions, Chinese consumer spending fell 5 percent from the previous year in November 2022, compared with a pre-pandemic growth of 7 percent in 2019 and a 10-year average growth rate of 12 percent.

On November 11, 2022, the Chinese Communist Party met and announced 20 measures to make COVID restrictions less onerous, as a first step to the end of zero COVID. An end to the zero-COVID policy has the potential to stimulate an economy held back by restrictions for the past few years, but it likely won’t be a smooth transition. China’s reopening unfolded at a surprisingly rapid pace during December 2022 and may be similar in 2023 to most other countries’ reopening experiences, with accelerating economic growth fueled by consumer spending and rising inflation. It’s not unreasonable to expect a surge in pent-up spending from 1.4 billion consumers after a year of restrictions, aided by soaring excess cash deposits and falling mortgage rates (see figure 7). With an initial period of increased economic activity, we also might see a resurgence in cases and receding growth as people call in sick, production slows, domestic supply chains become backlogged, and fearful consumers hesitate to venture out and risk potential infection. The willingness of people to travel (and the government to allow it) during the Lunar New Year holiday on January 22 will be key to watch, in particular during the cold of winter—when respiratory infections typically rise.

Reopening likely would benefit Chinese and global growth, as well as earnings of multinational companies selling into China. But a reopening China also may threaten to worsen the global inflation picture. The markets will have to balance earnings growth exposure from increased sales to Chinese consumers with the potential price increases in commodities and goods due to the rebound in demand. Because the Chinese took great lengths to avoid disruption in export production and global supply chains, it is unlikely we would see a global supply surge to help counter the inflationary effects of increased Chinese demand. Watch developments carefully to assess the balance between the impact of reopening excitement around growth prospects and inflation worries on the forward-looking stock market, which may move in advance of any impact on the global economy. Market participants’ disappointment at a resurgence in inflation, and any subsequent policy response by central banks, may overwhelm any improvement in the earnings outlook from increased business activity.

**INVESTING OPPORTUNITIES**

The stock market moved more than 5 percent up or down in each of the last six months of 2022—up more than 5 percent in July, October, and November and down more than 5 percent in June, August, and September. Volatility is expected to remain high in 2023 as central banks change tactics, a potential global recession lingers, and China’s reopening introduces upside risk to inflation. Efforts to rotate among groups of stocks to try to insulate from elevated volatility or try to time recovery may not be successful. There can be no guarantees, but investors may be able to navigate 2023 by sticking with what has been working in both up and down markets during 2022.

Rather than focus on the one sector, i.e., energy, or the one major country, i.e., the United Kingdom, that posted gains in 2022, note that some characteristics
performed well across and within sectors and countries in 2022, and we believe will continue to do so in 2023. We can refer to these characteristics as “quality.”

Sustainable and persistent high dividends tend to be a characteristic sign of good financial strength and cash flow. In every recessionary bear market during the past 50 years, high-dividend-paying stocks have outperformed the overall market, except for during the Global Financial Crisis in 2008–09 when financials were forced to eliminate dividends. The MSCI World High Dividend Index suffered a total return of ~3.9 percent in 2022—nearly flat and much better than the ~17.7 percent total return for the overall stock market as represented by the MSCI World Index. More importantly, high-dividend stocks outperformed while markets were volatile, both when the market was going down during the first three quarters of 2022 and when it was rising during the fourth-quarter rally (see figure 8).

Duration, usually a measure applied to debt instruments, also can be applied to stocks and used as a measure of quality to help manage the risk of rising interest rates. In our analysis, stocks with the more immediate cash flows, i.e., short-duration stocks, had outperformed stocks with cash flows in the distant future, i.e., long-duration stocks, since rates had bottomed in 2020. We find these higher-quality, short-duration stocks by ranking the constituents of an index, such as the MSCI World Index, using price to free-cash-flow ratios. The lower the ratio, the shorter the duration and the higher the quality. Short-duration stocks outperformed in 2022 when the market was falling and in the fourth quarter when it rebounded (see figure 9).

Recessions and bear markets, followed by recoveries, seem to coincide with the turning points of market cycles. The leaders of the last cycle tend to reverse and fall the most in the bear market while the recovery and next cycle tend to see new leaders. Figure 10 shows the relative performance of U.S. and international stock indexes. The lines are just the ratio of one index divided by the other. When the blue line is rising, international stocks are outperforming U.S. stocks. When the gold line is rising, U.S. stocks are outperforming international stocks. They are mirror images of each other, and these reversals can be observed around recessions in the 1970s and 2000s. During the late 1980s, there was about a decade of international stock market outperformance, with reversal coinciding around the 1990s recession. For more than 10 years now, the U.S. stock market has outperformed international markets, and it may be poised to reverse in this potential recessionary environment.

We had thought the 2020 recession would start the reversal, because...
recessions generally had marked the start of changes in relative performance. But the 2020 recession was too brief and saw too much stimulus further inflating U.S. growth stocks. Now, the likely coming recession may finally lead to international stocks outperforming as the Fed and other central banks have tightened—draining the liquidity that had been floating U.S. growth stocks.

After a year of dramatic inflation, economic and government policy shifts, and bear markets, investors might look forward to a slightly more friendly "bunny" market as 2023 begins. We expect some bounciness as investors evaluate the impacts of central bank actions, any spread of recession from manufacturing into the service sector, and global inflation’s path as demand in China rebounds with the nation’s exit from zero COVID. There also are other unknowns, because a new year tends to bring surprises in one form or another. Categories of external risks, such as geopolitical events, climate and weather-related events, and pandemics are an ever-present part of investing—difficult to forecast and not unique to the outlook for any particular year. As the year matures, easier financial conditions, stabilizing global growth, and easing inflation may aid a more stable recovery for stocks as a new cycle led by international stocks gets underway.

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Figure 10

TURNING POINTS OF MARKET CYCLES

Source: Charles Schwab & Co., Inc. Bloomberg data as of January 3, 2023. Indexes are unmanaged, do not incur management fees, costs, and expenses, and cannot be invested in directly. Past performance is no guarantee of future results.

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