

2023 Mid-Year Market Outlook: Out of the Woods?

✉ June 15, 2023 ▪ [Schwab Center for Financial Research](#)

The positives—and the risks—as we head into the second half of the year.



Most of the things we expected to happen during the first half of the year in fact did: Inflation eased, U.S. economic growth slowed, the Federal Reserve appears to be near the end of its rate-hike cycle, and the U.S. government debt ceiling standoff was resolved before a potential default.

One thing we didn't expect was the strength of the broader stock market. We had believed equity markets could face rough sledding in the first half, leading to a sunnier second half. In fact, the

S&P 500® index was up more than 13% year to date as of June 14th, while the Nasdaq composite was up more than 30%—unexpectedly strong performance, albeit driven by a handful of mega-cap stocks.

Fixed income market returns were positive through early June for nearly every asset class, from short-term Treasuries to high-yield corporate bonds, and we generally expect more of the same in the second half. We still find international stocks attractive, bolstered by more-attractive valuations and faster earnings growth, while recognizing that a surge in artificial intelligence (AI) stocks could further boost U.S. equities on a relative basis.

So are we out of the woods yet? No. The U.S. stock market could still experience bouts of volatility or weakness linked to ongoing uncertainty about Fed policy, weaker corporate earnings, possibly frothy investor sentiment, and the risk that the "rolling" recession—which has affected various geographies and industries at different times—will roll into a formal recession. Read on for a summary of our current views, with links to more-detailed reports.

U.S. stocks and economy: Mixed under the hood

Although broad stock index performance has been relatively strong YTD, performance under the surface has been [more reflective of the macro uncertainties](#) that persist, including:

- 1. Leading indicators are weak.** The Conference Board's Leading Economic Index (LEI)—which historically has a solid track record of leading economic tops and bottoms—is down nearly 10% from its peak 16 months ago.
- 2. Institute for Supply Management (ISM) prices are signaling lower inflation.** Prices within the manufacturing sector have fallen into contraction; services prices are easing but not yet contracting. The good news is this bodes well for the direction of inflation, but the rub is twofold. First, the decline in ISM services prices hasn't yet led to a similar decline in core services inflation metrics (which the Fed watches closely in calibrating its inflation-control actions). Second, should a significant decline in both ISM prices components occur, it could become historically consistent with a recession.
- 3. The labor market is showing cracks.** Getting inflation back in the bottle without a commensurate uptick in unemployment has been the Fed's goal throughout its hiking cycle. We continue to think it will be difficult to achieve. For example, the job-finding rate—which shows how many individuals who were previously unemployed are now able to find a job—has weakened and is at its lowest since September 2021. If the rate continues to move lower and jobless claims move higher, we'd expect cracks in the labor market to widen, giving way to weaker (if not negative) payroll growth.
- 4. A credit crunch may loom on the horizon.** Lending standards have tightened, which has implications for what is arguably the most important direct fundamental underpinning the stock market: corporate earnings. Based on historical lags of around three quarters, the tighter lending environment suggests more downside to S&P 500 earnings.

5. The market rally needs to broaden out. Stock market performance became "top-heavy" during the first half, with gains led by a handful of large stocks. It's not uncommon for the largest-cap stocks to dominate performance in cap-weighted indexes like the S&P 500 or Nasdaq, but when the majority of member stocks are underperforming the overall index, concentration risks become elevated. We have seen signs recently that the rally is beginning to broaden: At the end of May, only 15% of S&P 500 stocks had outperformed the overall index during the prior three months, but that had improved to 24% as of June 9th. A continued improvement would bode well for the market rally.

6. The surge in AI stocks could be a bubble. Adoption of ChatGPT, an artificial intelligence chatbot launched in late 2022, surpassed 100 million users in only two months. AI is likely to have a significant impact on how we live and work, as well as on productivity and perhaps longer-term inflation (or disinflation) trends. The rub is that the timing of all of this is uncertain, even if the enthusiasm is certainly elevated.

7. Investor sentiment could become frothy. One budding risk heading into the second half is investor sentiment. We look at myriad sentiment indicators—both behavioral and attitudinal—including NDR's Crowd Sentiment Poll, which is an amalgamation of seven distinct sentiment measures. For now, it's in the best zone (based on history) for stock market performance. The rub would be if rising optimism were to become excessive, which could shift the outlook to one of more volatility and/or bouts of weakness. We will be keeping a close eye on sentiment conditions as we transition to the second half.

Fixed income: The more things change...

Despite high volatility in the bond market during the first half of the year, what's surprising is [how much didn't change](#). Short-term yields rose as the Fed tightened policy, but yields for Treasury securities maturing in three years or more are nearly unchanged compared with the beginning of the year.

At its policymaking meeting in June, the Federal Reserve left rates unchanged but signaled the potential for more hikes later this year. That means higher short-term rates are still on the radar. However, we still expect yields of Treasury bonds maturing in two years or more to decline, as the forces that initially pulled them lower—tightening monetary and fiscal policies—should continue. The yield curve will likely remain inverted until there is a signal that the Fed is shifting to easier policy.

Because the economy responds to changes in Fed policy with a lag, the risks to growth and inflation appear skewed to the downside after more than a year of tightening policy. Moreover, fiscal policy has gone from a positive factor for the economy to a negative one. The "fiscal impulse," which measures the contribution of fiscal policy to gross domestic product growth, has shifted to a slight negative after surging during the pandemic.

Global stocks and economy: The Cardboard Box Recession

The second half may be marked by less drama, but milder returns for investors, due to effects from what we're calling the "[Cardboard Box Recession](#)." In a typical global recession, all areas of the economy turn lower. However, during much of the past year economic pain has been concentrated in manufacturing and shipping—segments whose product or service tends to involve a box. Demand for corrugated linerboard (what most cardboard boxes are made from) has fallen, commensurate with a pattern seen around past recessions dating back to 1997.¹ In contrast, services industries, which make up the largest share of output among developed economies, have continued to grow. The Global Purchasing Managers' Index gauge of services business activity remains well above 50, the threshold between contraction and growth.²

The narrow, tech-led advance in the U.S. stock market contrast with the broad performance of international stocks. An equal-weight index represents the “average” stock, with each stock getting the same weighing. The equal-weighted MSCI EAFE Index of international stocks is up well over 20% (measured in U.S. dollars) from the end of October 2022 through June 13th, 2023, meeting the technical definition of a new bull market. Yet the equal-weighted S&P 500 index is up only 5% over the same period. In general, the greater the number of stocks that are helping push the overall market higher, the more support the market has. The average international stock continues to outpace the average U.S. stock, offering a broader base of support for the bull market in international stocks.

We are still neutral on the performance of emerging-market stocks this year, which seem to remain dependent upon U.S.-China tensions as much as China's continued economic recovery (remember that Chinese stocks are the largest weight in the MSCI EM Index, at more than 30%). Geopolitical tensions seemed to have had negligible impact on China's domestically driven economic growth, but they did appear to weigh on China's stocks. Despite strong and better-than-expected economic performance, China's stock market fell after the spy balloon controversy erupted in early February. That slump disrupted a 60% three-month-long rebound that had existed from the end of October until this year's YTD peak on January 27th.

The second half of 2023 may hold the potential for fewer surprises, with a U.S. debt ceiling deal in place until early 2025, global central banks moving toward a pause on rates, bank stress stabilizing, and signs of potential U.S.-China tensions cooling. The pause in international stock market leadership in May could resume in the second half of the year, although stocks may face headwinds if weakness spreads into services industries as both inflation and job growth ease.

¹ Source: Fibre Box Association, as of 6/2/2023.

² The Global PMI services business activity index was above 55 in May, according to S&P Global.

Get Schwab's view on markets and economy.

[See all commentary](#)

More from Charles Schwab

[MARKETS AND ECONOMY >](#)

Economic News Lifts Stocks



[OPTIONS >](#)

Today's Options Market Update



[MARKETS AND ECONOMY >](#)

Closing Market Update: Economic News Lifts Stocks



Related topics

[STOCKS](#)

[BONDS](#)

[FIXED INCOME](#)

[MARKETS AND ECONOMY](#)

[INTERNATIONAL](#)

[US](#)

The information provided here is for general informational purposes only and should not be considered an individualized recommendation or personalized investment advice. The investment strategies mentioned here may not be suitable for everyone. Each investor needs to review an investment strategy for his or her own particular situation before making any investment decision.

All expressions of opinion are subject to change without notice in reaction to shifting market conditions. Data contained herein from third-party providers is obtained from what are considered reliable sources. However, its accuracy, completeness or reliability cannot be guaranteed. Supporting documentation for any claims or statistical information is available upon request.

Examples provided are for illustrative purposes only and not intended to be reflective of results you can expect to achieve.

Forecasts contained herein are for illustrative purposes only, may be based upon proprietary research and are developed through analysis of historical public data.

The policy analysis provided by the Charles Schwab & Co., Inc., does not constitute and should not be interpreted as an endorsement of any political party.

The information provided here is for general informational purposes only and is not intended to be a substitute for specific individualized tax, legal or investment planning advice. Where specific advice is necessary or appropriate, consult with a qualified tax advisor, CPA, financial planner or investment manager.

Investing involves risk including loss of principal.

Past performance is no guarantee of future results and the opinions presented cannot be viewed as an indicator of future performance.

All corporate names and market data shown above are for illustrative purposes only and are not a recommendation, offer to sell, or a solicitation of an offer to buy any security.

Diversification strategies do not ensure a profit and do not protect against losses in declining markets.

Indexes are unmanaged, do not incur management fees, costs, and expenses, and cannot be invested in directly. For additional information, please see schwab.com/indexdefinitions.

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. Lower-rated securities are subject to greater credit risk, default risk, and liquidity risk.

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.

0623-3ACK

Brokerage Products: Not FDIC Insured ■ No Bank Guarantee ■ May Lose Value

The Charles Schwab Corporation provides a full range of brokerage, banking and financial advisory services through its operating subsidiaries. Its broker-dealer subsidiary, Charles Schwab & Co., Inc. ([Member SIPC](#)), offers investment services and products, including Schwab brokerage accounts. Its banking subsidiary, Charles Schwab Bank, SSB (member FDIC and an Equal Housing Lender), provides deposit and lending services and products. Access to Electronic Services may be limited or unavailable during periods of peak demand, market volatility, systems upgrade, maintenance, or for other reasons.

This site is designed for U.S. residents. Non-U.S. residents are subject to country-specific restrictions. Learn more about our services for [non-U.S. residents](#).

© 2023 Charles Schwab & Co., Inc. All rights reserved. [Member SIPC](#). Unauthorized access is prohibited. Usage will be monitored.



Own your tomorrow.

[Site Map](#) | [SchwabSafe](#) | [Privacy](#) | [Online Privacy](#) | [Additional Schwab Sites](#) | [Business Continuity](#) | [Financial Statement](#) | [Accessibility Help](#) | [Contact Us](#) | [About Schwab](#) | [Careers](#) | [Investment Professionals' Compensation](#) | [Important Notices](#) | [SIPC®](#) | [FDIC Insurance](#) | [FINRA's Broker Check](#) | [Bank Client Complaints](#) | [Client Relationship Summaries](#)