

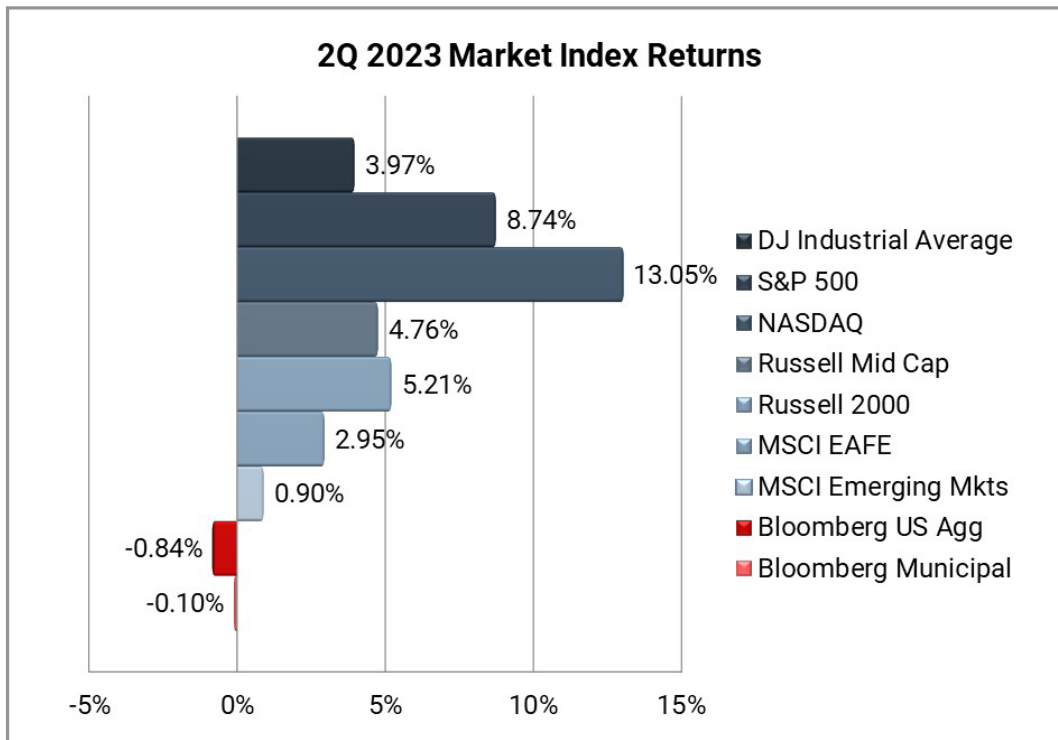
## QUARTERLY MARKET COMMENTARY: *Second Quarter 2023*

### the ECONOMY

The ongoing positive momentum in financial markets in 2023 is enough to make one forget several challenges global stocks have had to overcome to generate a near 14% year-to-date return. Not long after the Silicon Valley Bank fiasco in March, another large U.S.-based bank, First Republic, was seized by the Federal Deposit Insurance Corporation (FDIC) and ultimately sold to J.P. Morgan. Soon after, a hostile debate over raising the debt ceiling took center stage, all while inflation was still running hot with global central banks intent on raising interest rates high enough to quash it. Enough to make any investor uncertain.

But it seems that the old adage about stock markets climbing a “wall of worry” has been the case yet again.

And while we don’t want to discount the risks to the market, so far economies and corporate earnings have proven resilient, especially in the U.S. Heading into the year there was a growing consensus that a recession was an increasingly likely



probability. But a full-blown recession isn’t showing up in the latest data, particularly with regard to the labor market. Through May, the economy has added an average of 314,000 jobs per month in 2023. The labor force participation rate amongst so-called “prime-age workers”, those between 25 – 54 years of age, has also increased from 82.4% to 83.4%, representing hundreds of thousands of new entrants into the employment market. These steady job gains have helped support broad consumer spending, which has been the primary driver of GDP growth this year. The first quarter came in at a 2% annual rate, and the Atlanta Federal Reserve is projecting the same for the second.

Inflation is still an issue for consumers of course but has seen meaningful improvement this year.

At the end of 2022, the Consumer Price Index (CPI), had increased 6.4% over the trailing 12 months. Currently though, that number is down to 4.1%, and we see reasons for further slowing ahead. Shelter makes up about one-third of the CPI calculation but tends to lag behind what we would consider more real-time home and rent price data. This real-time data shows almost no aggregate increase over the past year and should eventually find its way into the official inflation stats, putting downward pressure on the headline CPI number.

Europe's growth hasn't matched that of the U.S., but still experienced rising levels of activity and employment through the first half of the year. A slowdown in manufacturing though, does threaten to tip the continent's largest economy, Germany, into a mild recession. Inflation is improving here as well, with the official measure now at 6.1%, down from 9.2% at the end of 2022.

Further east, after years of "zero-COVID" policy, China's reopening is set to continue, but the strength of the recovery has been less than anticipated. The trend among Western developed nations to bring manufacturing capacity back home, referred to as onshoring, or move production to countries with which a better relationship exists, called "friend-shoring", may be a headwind to growth. Japan though, is poised to be a beneficiary of that trend. Its labor costs are reasonable, has a stable government, and a renewed focus on efficiency in the corporate sector has led to several business-friendly policies. We think this is at least part of the reason why Japan's Nikkei 225 stock index is near a three-decade high

## CENTRAL BANKS

While recent bank failures have given the Federal Reserve (Fed) something additional to think about, it did move forward with another interest rate increase in May. The target range for the federal funds rate is now 5 – 5.25%. And while the Fed did decide to forgo any further action following the June meeting, a majority of senior Fed officials still believe further interest rate increases should be on the table. With few signs of deterioration in the labor market, they likely believe there is cover for more policy tightening if inflation does not fall quickly enough.

The European Central Bank (ECB) has been following in the Fed's footsteps, raising its key interest rate aggressively, currently up to 3.5%. In general, Europe's inflation problem has been more impacted by seesawing energy prices resulting from the ongoing war in Ukraine, making the ECB's longer-term rate target more difficult to forecast.

## BONDS

A key theme of ours this year has been that after a rough 2022 for bond investors, future returns ought to look much better. This has been true through the first half of 2023 overall, but fixed-income securities did suffer a modest setback in the second quarter. Core investment-grade bonds fell 0.84%, as yields resumed their uptrend after a brief respite following the Silicon Valley Bank failure (current bond prices generally fall as yields rise). The biggest change in interest rates came from shorter-term securities. The 2-year U.S. Treasury, for example, started the second quarter at 4.04% but finished at 4.90%. Municipal bonds held up better than their taxable peers, falling just 0.10%. We still believe that in aggregate, municipal credit quality is in very good shape, with state and local governments generally

in solid financial health.

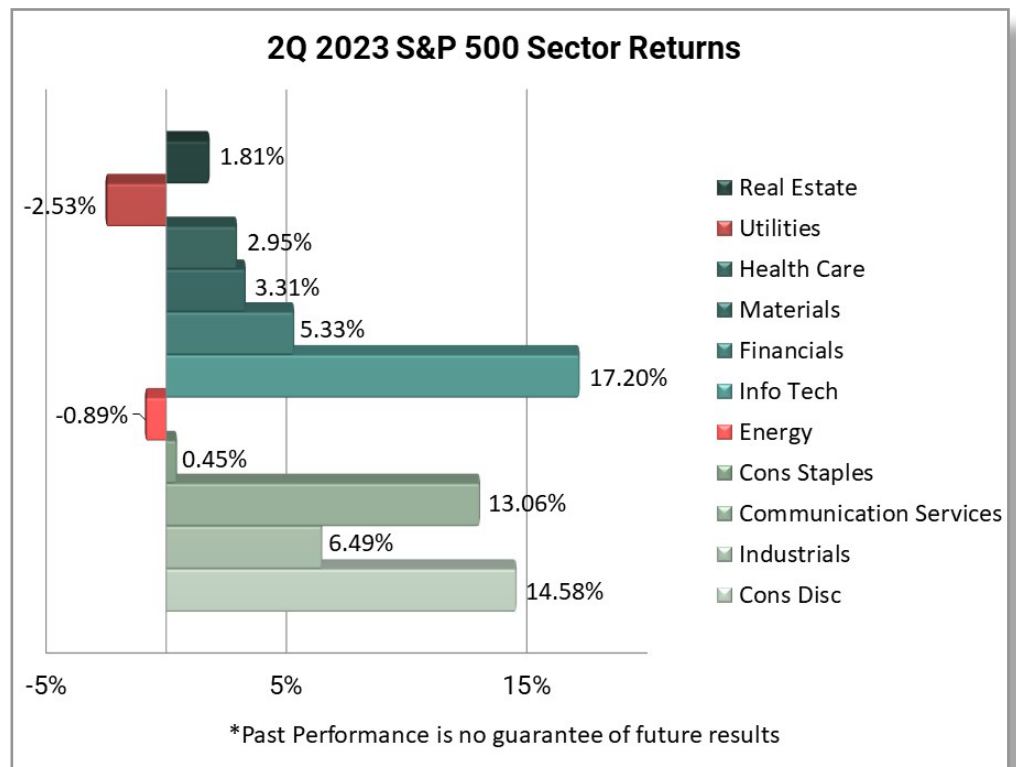
Outside of the core investment grade market, lower-rated high-yield bonds actually delivered solidly positive performance, up 1.63%. We track this market very closely as an economic indicator since the types of companies that issue these bonds tend to be the first to run into trouble if the economy weakens. The fact that these securities are still trading well suggests that investors currently have a relatively favorable view of corporate balance sheets and the economic outlook.

## STOCKS

Following the banking turmoil in early March, there was a rapid rotation among stock market sectors by investors. Perhaps not surprisingly, anything financials-related was sold with a big chunk of the proceeds reallocated towards technology for its perceived safety and growth characteristics. This led to historically wide performance dispersion in the first quarter. This trend was then further reinforced following the release of ChatGPT, a large language model utilizing state-of-

the-art artificial intelligence (AI). The excitement surrounding AI provided even more reason to pile into technology stocks, leading to a historic 31.7% gain for the tech-centric Nasdaq Composite index through the first of the year. A phenomenon we're keeping a close eye on, though, is the "top heaviness" of the current market. Meaning that a disproportionate share of market gains this year have been driven by just a few large stocks, whereas a typical rally also features broader participation amongst smaller cap securities.

Outside of the U.S., returns were more modest but still positive. The MSCI EAFE Index of international developed country stocks rose 2.95%, led by Japanese shares. Emerging markets rose just 0.90%, as investors were quick to take profits on Chinese shares following the country's reopening. A few other bright spots internationally include India and Brazil, both of which have stock markets that are trading at relatively low prices while their respective economies have gained steam. Both were up double digits in the second quarter.



## OUTLOOK

Last quarter we suggested that the most pressing concern for financial markets was the recent tumult in the banking sector, but that we believed the damage would be contained. First Republic aside, that seems to be the case so far. We see little evidence of broader systemic issues amongst financial institutions. That said, banks are clearly tightening lending standards and prioritizing balance sheet health over loan growth at the moment. This is prudent, but less credit flowing to the economy could mean slower growth going forward.

As long as the labor market remains strong though, the economy ought to be resilient. There are still over 10 million current job openings, well above the number of unemployed people. Historically, tight labor markets, such as this one, have been less likely to suffer meaningful job losses. Also, estimates point to roughly \$500 billion of excess savings left over from the COVID stimulus and lockdowns, which should continue to support consumer spending beyond what is usually assumed from looking at job and wage gains.

Falling inflation should help as well. But while we do think inflation is poised to continue decelerating, absent outright deflation, there's not necessarily a clear path back to the Fed's 2% target in the near term. And it's still an open question as to whether the Fed needs to see 2% exactly or would be comfortable with something close to it. In either case, since it may not be until 2024 when we see those numbers, the Fed may not be as inclined to start reducing interest rates as quickly as investors expect.

Another potential boost to the economy is both residential and non-residential construction. Due to rising mortgage rates and reduced affordability, we don't anticipate much of a pick-up in home price appreciation or existing sales. But due to low inventory, new homebuilding, both single and multifamily, is experiencing a resurgence in activity. Also, the trend towards onshoring and friend-shoring, while tepid at first, is leading to increased investment in manufacturing facilities in both the U.S. and Europe.

We also think emerging markets are poised for continued solid growth this year. In general, emerging market economies already have higher interest rates, and central banks are more likely to cut rates to boost growth sooner rather than later. And although China's reopening has disappointed, the fact that it is open at all is a significant benefit to surrounding Asian economies.

In addition to the aforementioned slowing credit growth, there are a few other risks that are top of mind for us. One is that a collection of business and consumer confidence surveys have been relatively weak. Not necessarily pointing towards a recession, but not the levels associated with a robust expansion either. Another is the previously discussed concentration in the U.S. stock market, which has seen a handful of mega-cap companies drive performance. The concentration alone is a risk, but it has also pushed valuations up to 19 times earnings estimates, above the long-term average. This leaves less margin for error should the economy or some combination of those companies undershoot lofty expectations.

In summary, the global economy has held up well, defying the outlook of many. The first half surge in stock prices is a testament to that. But given the risks we mentioned, we believe it's now more important than ever to stick to a disciplined investment strategy and maintain a well-diversified portfolio. As always, we will continue to monitor the market environment and position portfolios accordingly in response.

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