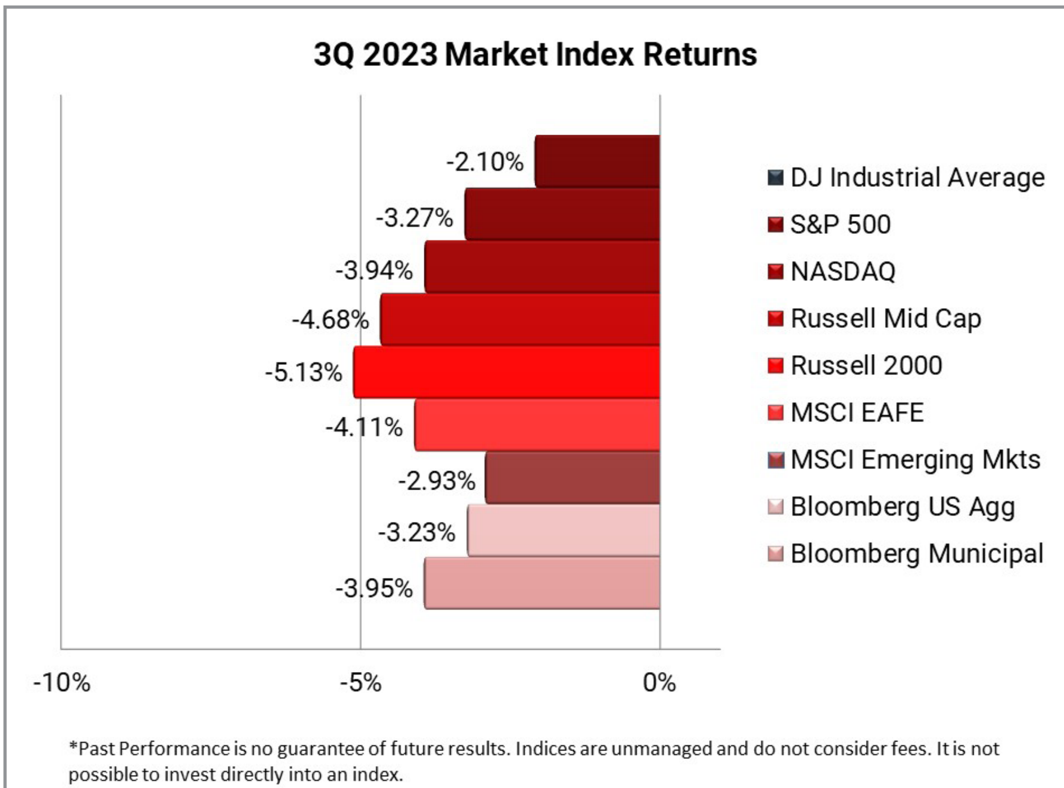
LINSCOMB WILLIAMS

WEALTH MANAGEMENT SINCE 1971

QUARTERLY MARKET COMMENTARY: *Third Quarter 2023*

the ECONOMY

While stocks have still delivered solid returns year-to-date, the third quarter was certainly a more volatile environment compared to the first half of 2023. A further rise in interest rates, higher oil prices, weaker growth overseas, and a potential government shutdown here in the States have all weighed on investor sentiment recently. But with those challenges in mind, the correction in stocks over the past three months is a normal and expected part of investing, and in fact, has been much milder than what occurs in an average year. The global economy has also proven resilient, so far avoiding the widely predicted recession that was called for by many in late-2022.



The U.S. especially has continued to turn in steady growth. The GDP growth rate averaged 2% for the first 6 months of the year and consensus expectations are for an increase in the third quarter. The primary driver of this growth has been consumer spending which is supported by a labor market that remains in good shape. Job growth has averaged 236,000 per month this year with the unemployment rate still near cycle lows at 3.8%. Wage growth that is now running ahead of inflation has also drawn more potential workers off the sidelines. We can see this is the labor force participation rate – the percentage of the population either working or actively looking - which is currently at 62.8%, up from 62.3% at the beginning of the year. We also keep a close eye on initial jobless claims, a good real-time proxy for layoffs, which are near an all-time low. So, while job growth is likely to slow as the pool of available workers shrinks, for the time being, companies are reluctant to let employees go. The bottom line is that as long as people have stable employment, consumer spending typically remains positive and keeps the economy on solid ground.

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 3.7%. To be sure, there has been a modest increase in the past 2 months as oil prices are back above $90 a barrel. The rise in energy prices is being offset somewhat by the shelter component of the CPI which tracks rent and housing prices, but with a multi-month lag. Aggregate national data show little to no increase in overall shelter prices over the past year, which should eventually flow through to a lower CPI calculation. Speaking of housing, we'd be remiss not to mention higher mortgage rates, which have led to a significant downturn in existing home transactions and appear to be a headwind for new builds as well.

Europe's economy is growing, albeit at a slower rate than the U.S., likely closer to 1%. And similar to the U.S., it is mainly a strong labor market and consumer spending that is responsible for that growth. Inflation also continues to improve, with the official measure down to 5.2%, compared to 9.1% at the end of 2022. We are keeping an eye on manufacturing activity though, which has experienced a notable slowdown.

If the resilient growth of the U.S. and Europe can be considered positive surprises, we'd put the disappointing expansion in China on the negative side of the ledger. Reopening of the country's economy following years of strict "zero-COVID" policy was expected to lead to a surge in activity, however, issues in the real estate sector have persisted and consumers have been reluctant to spend down elevated savings built up over the pandemic period. China's export volumes have also been weaker as low-cost manufacturing has in many cases either moved to other countries or been automated away. It's still early but Japan is poised to be a beneficiary of these trends. It is already a leader in factory automation and there is a nationwide focus on corporate efficiency and the creation of a more business-friendly environment.

CENTRAL BANKS

We mentioned last quarter that because there were few signs of deterioration in the labor market and that inflation remained above target, the Federal Reserve had cover for further policy tightening. Chair Jerome Powell and Fed officials did decide on one further interest rate increase, bringing the target range for the key short-term interest rate to 5.25% - 5.50%. One important change following the latest Fed meeting though was the expectation for interest rates in 2024. Previously the guidance was for a series of cuts, but now Fed members see little change from current levels.

The European Central Bank (ECB) has been following in the Fed's footsteps, raising its key interest rate aggressively, currently up to 4.0%. 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. The Bank of Japan (BoJ) has been the lone holdout, keeping its interest rate target near 0%.

There's enough evidence in our opinion that inflation rates have moved sufficiently in the right direction that we don't believe global central banks need to tighten money policy much further, if at all. However, we wouldn't expect a meaningful lowering of interest rates in the near future either.

BONDS

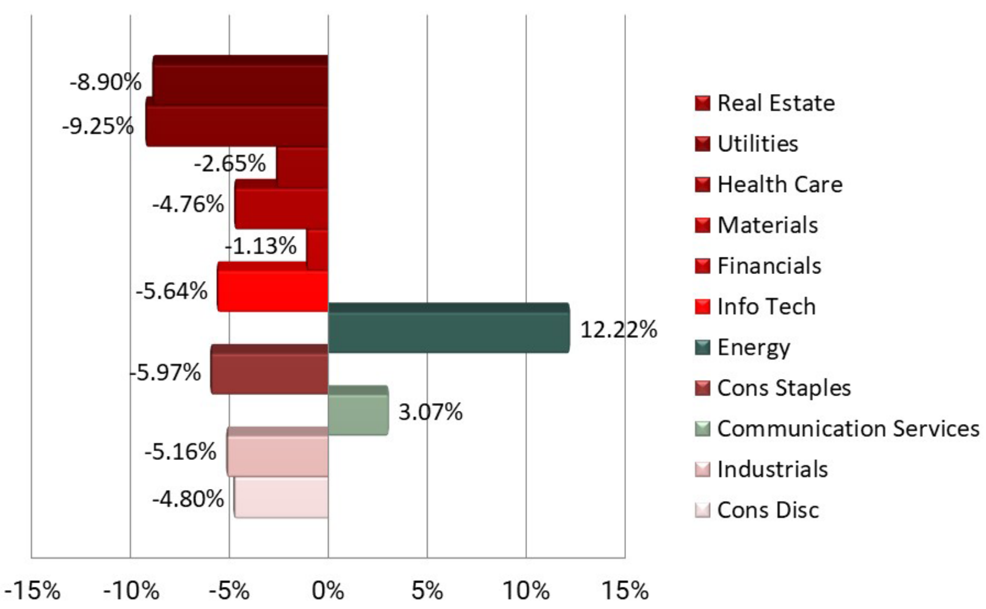
Higher starting yields will benefit bondholders over longer holding periods, but in the short-term prices can and will fluctuate based on interest rate movements. So, the recent rise in interest rates, especially in September, did take a toll on fixed-income returns. The 10-year U.S. Treasury rate, for example, started the quarter at 3.81% but closed at 4.57%. Core investment-grade bonds in turn experienced a relatively poor quarter, falling 3.23%. Municipal bonds suffered as well, down 3.95%. We still believe that overall, municipal credit quality is in very good shape, with state and local governments generally in solid financial health. So, this was primarily an interest rate issue, rather than any real concern about the ability for municipalities to repay their debt.

We'd also note that the shape of the yield curve is still inverted, meaning that short-term rates are higher than longer-term ones, which is historically an unusual occurrence. It is often cited as a harbinger of a recession, but this phenomenon has persisted for over a year without one occurring.

STOCKS

This year's market advance took a pause in the third quarter, with the S&P 500 falling 3.27%. Energy was a standout sector that delivered positive returns, rising 12.22% alongside the increase in oil prices. Lagging sectors include utilities and real estate, both of which tend to be more sensitive to changes in interest rates. The NASDAQ, which has benefited greatly from the enthusiasm surrounding artificial intelligence, modestly underperformed the broader market, falling 3.94%. Overseas it was a similar story, with international and emerging market stocks declining 4.11% and 2.93%, respectively.

3Q 2023 S&P 500 Sector Returns



*Past Performance is no guarantee of future results. Indices are unmanaged and do not consider fees. It is not possible to invest directly into an index.

One phenomenon we're monitoring is the increasing concentration of the U.S. stock market. Presently, the 10 largest stocks make up nearly 32% of the entire S&P 500. This sort of "top-heaviness" is something we haven't seen in decades. We believe maintaining diversified exposure to equities in this environment takes on additional importance.

OUTLOOK

The pressing concern for investors through the first half of 2023 was the failure of a number of large regional banks and the potential for broader contagion throughout the financial system. We can't say for certain that the banking sector is out of the woods, but it appears that the acute phase of the panic has passed with relatively minimal damage to the overall economy. That said, there is clearly pressure on bank balance sheets and lending standards are tightening. This is prudent in our opinion, but less credit flowing to the economy could mean slower growth going forward.

Historically, if the labor market stays in good shape, the U.S. and global economy have generally remained in growth mode. This, in our opinion, is one of the main reasons consumer spending has remained strong and calls for a recession this year have failed to materialize. There has been a deceleration in certain metrics that we track. Current job openings are down to 8.8 million compared to a peak of over 12 million last year. Voluntary quit rates and temporary help services have also slowed but both are still at levels consistent with a steadily growing economy. In fact, the Fed likely wants the labor market to cool off, hoping it helps the fight against inflation.

On inflation, the trend in core CPI, which excludes food and energy, is clearly heading in the right direction. Over the past three months, this measure has averaged 2.4%, the lowest rate we've calculated since early 2021. Of course, though the Fed likes to focus on this core number, food and energy prices do have a meaningful impact on consumer spending and the broader economy. So, the recent rise in oil could pose a headwind through the rest of this year and into 2024. It also potentially complicates the Fed's desire to put an end to this interest rate hiking cycle.

Another relative bright spot in the U.S. economy has been investment in manufacturing and non-residential construction. The trend towards onshoring and near-shoring does seem to have led to new projects starting up at a faster pace than we've seen in prior years.

Internationally, both Europe and Japan have slowed compared to the first half of the year, but their respective economies are still growing. The unexpected weakness out of China represents a risk to that growth as it is a major trading partner for both.

A few other dynamics we're keeping an eye on include commercial real estate, consumer confidence and excess savings, as well as the U.S. political situation. In the commercial real estate sector, office buildings in particular are still facing headwinds as vacancy rates in many cases may be permanently elevated. Following the pandemic, massive government stimulus left consumers with a significant amount of excess savings above and beyond what a more typical environment would dictate. These savings have been a massive tailwind for consumer spending but do look like they've been exhausted at this point. And though a government shutdown appears to have been averted for the time being, it could potentially return as an issue before year-end.

In summary, the global economy has held up well, defying the outlook of many. And though markets were down in the third quarter, the solid year-to-date performance is reflective of that economic resilience. But given the risks we mentioned, especially the U.S. market concentration, 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.

Linscomb & Williams
1333 West Loop South, Ste. 1500 Houston, TX 77027
P 713 840 1000   **F** 713 840 7802
www.linscomb-williams.com

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