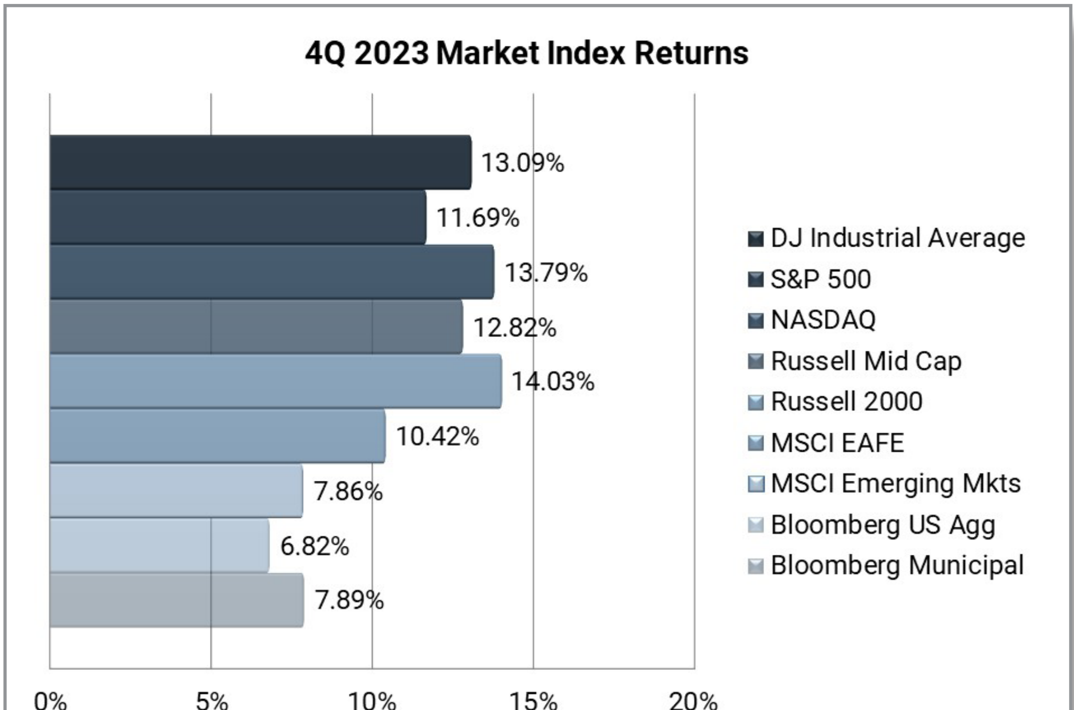
LINSCOMB WILLIAMS

WEALTH MANAGEMENT SINCE 1971

QUARTERLY MARKET COMMENTARY: *Fourth Quarter 2023*

the ECONOMY

We've always found it fascinating how quickly narratives surrounding the economy and financial markets can shift. And the shift is often dramatic, moving from widespread gloom to unbridled optimism and vice versa. Just look at the past 12 months. At the close of 2022, it was uncontrolled inflation, no end in sight to higher interest rates, and a near-certainty of a meaningful economic slowdown or outright recession. But today, inflation is significantly less, the Federal Reserve has indicated plans to lower short-term interest rates, and it's widely believed that the economy will experience a so-called "soft landing" or perhaps no landing at all.



*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.

What we know about financial markets is that they don't necessarily react to outcomes in isolation, but rather to those outcomes relative to expectations. So, while there may not be one, big, obviously identifiable catalyst for the strong performance in both stock and bond markets in 2023, just the fact that those aforementioned negative outcomes were avoided was sufficient to generate favorable results for investors.

When we look at the global economy, the U.S. in particular stood out as an area of strength last year. Third quarter GDP came in at an impressive 4.9% and the consensus is calling for another positive quarter in the fourth. Consumer spending has been the primary driver of this growth, supported by a labor market that remains in good shape. Over the past three months, job gains have averaged 165,000 per month, and as of year-end the unemployment rate was at 3.7%. It is important to note that the rate of job growth has slowed as the pool of available workers shrinks, but for the time being companies appear very reluctant to let employees go. Initial jobless claims, a good real-time proxy for layoffs, remain near all-time lows relative to the size of the labor force. As long as people have stable employment, consumer spending typically remains positive and keeps the economy on solid footing.

On inflation, the Consumer Price Index, or CPI for short, last checked in at 3.1% over the past 12 months. That's down from 6.4% at the end of 2022. We'd expect some further downward pressure on inflation in the coming months as the housing and rent component, which make up one-third of the CPI calculation, continues to trend lower. Regarding the housing market, though mortgage rates did decline in the fourth quarter, they are mostly unchanged compared to this time last year and remain a headwind to transaction volume. Existing home sales are down close to 10% over the past year. Where we have seen some pick-up in activity is new home building, with builders focusing on construction of lower-priced residences in response to affordability issues in existing housing stock.

Another factor that may have boosted economic growth in 2023 is federal government spending. Various policy initiatives including the CHIPS Act and Inflation Reduction Act appear to have incentivized new construction projects here in the U.S. The flip side though is the government is now running large fiscal deficits, the size of which are generally unseen outside of wars and recessions.

Overseas, Europe's economy did grow reasonably well through the first half of the year but looks to have stagnated in the second. Manufacturing activity has slowed globally, which has been a challenge for some of Europe's export-oriented economies. Europe's battle against inflation does seem farther along compared to the U.S. though, with headline price increases coming in below 3% for three months in a row. In aggregate, Europe provided far less direct fiscal stimulus during the COVID pandemic, which may have meant less inflationary pressure from the demand side and left respective member governments in better fiscal health.

Japan's economy did surprise to the upside in our opinion, outperforming expectations in 2023. Its government recently raised its growth projections for 2024 as well. It is one of the few developed world economies without an inflation problem, and in fact, is actually welcoming modest price increases as an antidote to a long-entrenched deflationary mindset. The Nikkei 225, the Tokyo Exchange's stock market index, rose over 30% last year, which we think reflects those positive dynamics.

In emerging markets, China muddled through 2023 as lingering real estate issues and falling consumer confidence have its economy in a relatively moribund state. The desire to reconfigure supply chains following COVID-related disruptions does appear to have benefited a number of emerging countries though. In Asia, both India and Vietnam have received increased investment from the developed world, and closer to home Mexico recently overtook China as the U.S.'s top import partner.

CENTRAL BANKS

Further progress on inflation here in the U.S. has investors convinced that the Fed is done raising interest rates for the foreseeable future, and we'd agree with that assessment. While we don't expect any immediate change from the current policy stance, the consensus forecast is for a series of rate cuts throughout 2024. That would bring the federal funds rate down from 5.5% to somewhere in the 4% range. If inflation continues to trend lower, this seems reasonable to us. But as long as the labor market remains in good shape, we don't think the Fed will be in any hurry.

The European Central Bank (ECB) is following a similar path, with expectations for rates to be lowered sometime in the first half of 2024. The Bank of Japan (BoJ) however is in a different situation. After years of holding interest rates at negative levels, with limited evidence of success, it is now finally considering abandoning that policy. As we mentioned earlier, Japanese government and central bank officials would prefer a bit more inflation going forward.

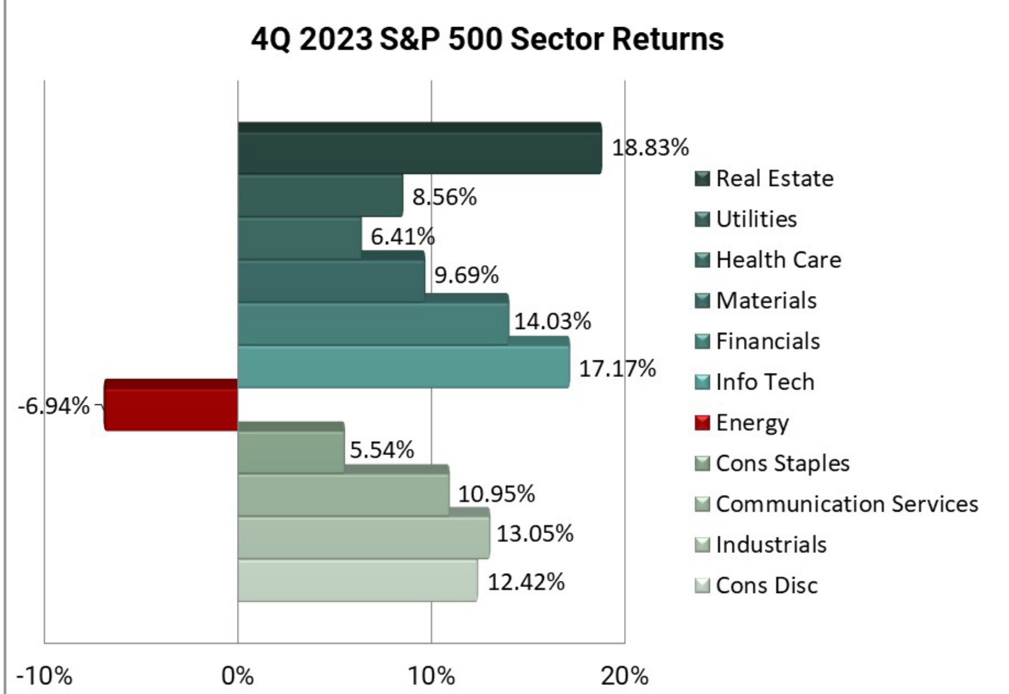
BONDS

It's often noted that timing the stock market is a poor long-term strategy, but the same idea likely applies to bond markets and interest rates as well. For example, from early April through the end of September the 10-year U.S. Treasury yield rose from 3.51% to 4.63%. Rising interest rates, especially over such a short duration, can lead to downward pressure and paper losses on fixed-income securities. So, needless to say, that time period was a poor one for bond performance. However, sticking with a bond allocation paid off handsomely in the fourth quarter. Interest rates on both government and corporate bonds fell significantly, leading to a 6.82% gain for the Bloomberg U.S. Aggregate Bond Index over the final three months of 2023. In fact, the entirety of last year's return for fixed income occurred in the fourth quarter. Just like in the stock market, it pays to stay invested. The tax-free segment of the market followed a similar pattern with the Bloomberg Municipal Bond Index up 7.89% in the fourth quarter.

STOCKS

Though last quarter began in the midst of a market correction the year ended on a positive note. The S&P 500 gained 11.69% over the final three months of 2023, led by an interesting collection of sectors. Technology, which was a leader for most of the year, climbed 17.17%. But real estate, which was still sporting negative returns heading into October, rallied 18.83%, likely helped by the decline in interest rates. Financials as well, which had generally been treading water since the Silicon Valley Bank fiasco in March, turned in strong performance, rising 14.03%. Energy stocks were the laggard, declining 6.94% as oil prices fell back into the low $70's, down from above $90.

Outside of U.S. large-cap stocks, small-cap shares caught a strong bid for the first time in 2023. The Russell 2000 Index gained 14.03% in the fourth quarter. Foreign securities also delivered solid performance, with the MSCI EAFE and Emerging Markets indices rising 10.42% and 7.86%, respectively.



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We think it's important to note that the fourth quarter market rally was broader than it has been for much of the year. Market breadth typically refers to the number of stocks within an index or market that are rising relative to those that are falling. Until the fourth quarter, the majority of the market gains were concentrated in the top 10 stocks within the S&P 500, and it is generally considered a sign of market health that other sectors and securities have begun to catch up.

OUTLOOK

Famous value investor Ben Graham once said "In the short run, the market is a voting machine" referring to the way short-term price swings in markets mostly reflect the opinions and emotions of investors, which can be flighty, capricious, and often based on little real-world evidence. We think market behavior over the past 12 months is a testament to the truth of that statement.

Sentiment has shifted from one of despair at the start of 2023 to something much more encouraging today, with investors believing the constructive investment environment is set to continue. Year-to-year stock market performance is notoriously difficult to predict, but we do see reasons for the improved outlook.

As we discussed earlier, the U.S. economy is on solid footing, and we don't see an immediate reason for concern. Though job growth has slowed, it is still positive and ought to continue to provide support for consumer spending. Higher interest rates will impact consumers' willingness and ability to borrow, especially for larger purchases, but overall households look financially healthy to us. Credit card and auto delinquency rates have ticked higher though, and this bears monitoring. Corporate balance sheets as well are strong overall, with relatively high cash balances and low debt levels. Credit spreads, or the difference in yield between a corporate bond and a comparable Treasury security, are at historically tight levels, suggesting that bond investors see little risk of default in the future.

Regarding inflation, we'd reiterate that we think it should trend lower, though getting from 3% to 2% may be more of a challenge than going from 6% to 3%. Call it the "last mile" problem to borrow a supply chain term. Even though we're not at the Fed's 2% target yet, we do think there's enough evidence that the majority of the inflationary shock is behind us and that the Fed will commence lowering short-term rates at some point in 2024.

Declining oil prices have also been a tailwind for both falling inflation and consumer spending. Ongoing geopolitical conflicts in the Middle East and Europe bear watching though. U.S. production has increased dramatically in recent decades, but turmoil in that part of the world has historically been associated with higher oil prices.

Another item to keep an eye on is, of course, the 2024 election. Presidential election years in the U.S. do tend to come with more financial market volatility than a typical year, but there's no consistent pattern when it comes to returns. And it's not just the U.S. that goes to the polls, a number of important elections in places like Taiwan, Mexico, India, and across Europe are also on deck.

A few other dynamics in play include the ongoing adjustment in commercial real estate, especially office buildings, the potential exhausting of "excess" consumer savings, and increasing investment in artificial intelligence. Regarding the latter, ex-Microsoft CEO Bill Gates said, "We always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next ten." That makes sense to us. The world may not look much different at the end of 2024, but AI will likely open new opportunities in the coming decade.

In summary, the global economy has largely held up well, defying the outlook of many. Strong asset market performance is reflective of that 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.

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The **S&P 500 Index** is considered generally representative of the U.S. equity market and its market cap is weighted. The **Bloomberg U.S. Aggregate Bond Index** is a broad-based benchmark of the U.S. investment grade and global investment grade bond market. They include Treasury, government related, corporate and securitized fixed-rate bonds. The **Bloomberg Municipal Bond Index** is a benchmark of U.S. long-term tax-exempt bond covering four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds. The **MSCI Emerging Markets Index** is a measure of the performance of emerging market equities. The **MSCI EAFE Index** is a measure of large and mid-cap equity performance across 21 developed countries, ex U.S. and Canada. The **Russell 2000 Index** is a measure of U.S. small cap performance. The **Russell Midcap Index** is a measure of U.S. mid-cap performance. The **DJ Industrial Average** is a price-weighted measure of 30 U.S. blue-chip companies covering all industries except transportation and utilities. The **NASDAQ Composite** is a broad based, market cap weighted index of more than 3,700 stocks listed on the Nasdaq stock exchange.

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