

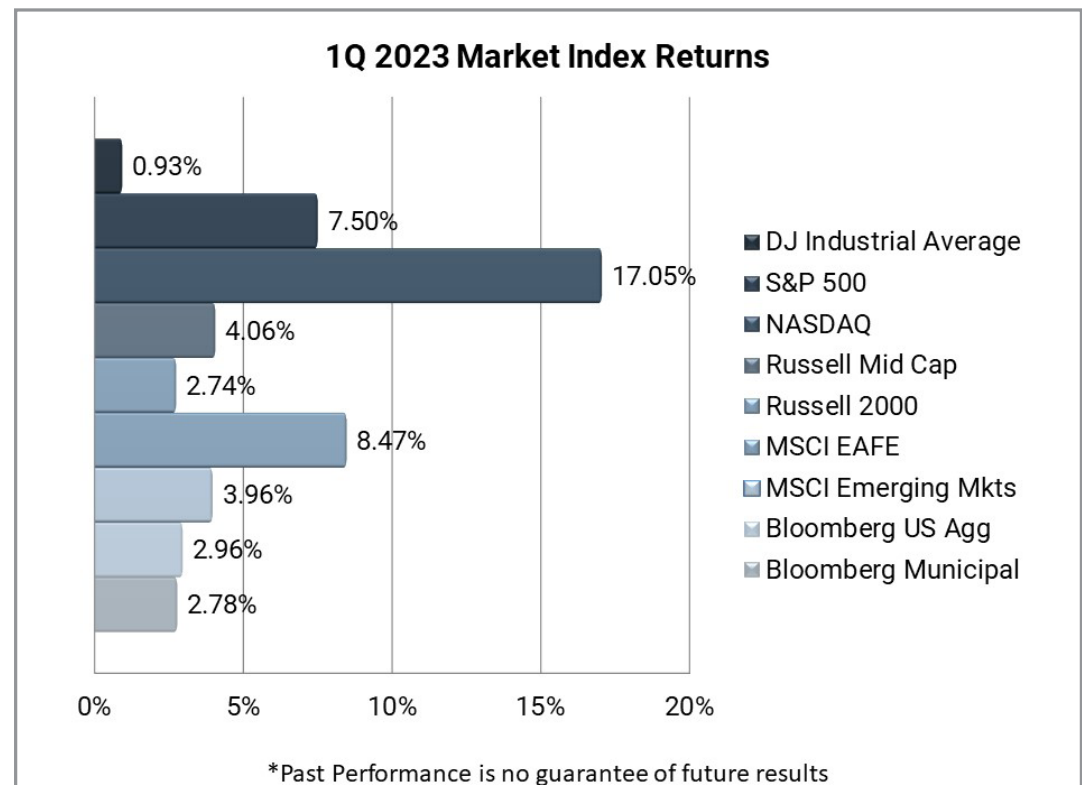
QUARTERLY MARKET COMMENTARY: *First Quarter 2023*

the ECONOMY

One of the more intriguing characteristics of financial markets in our opinion is that, even if one were able to predict future real-world events with pinpoint accuracy, that information may not necessarily be of much use to investors. The first quarter of this year is a salient example. Here in the U.S., the collapse of Silicon Valley Bank in March and Signature Bank soon thereafter represented two of the three biggest bank failures in U.S. history. Overseas, Credit Suisse, which traces in lineage back to the 1850s, was abruptly taken over by rival bank UBS at the behest of Swiss regulators. Yet despite that turbulence, stocks continued to rebound from their October nadir.

Thinking back on the environment near those lows, there was a relatively widespread consensus amongst market participants that a recession in Europe was imminent, or at least nearly so, and that the U.S. was soon to follow. As it turns out, that recession has been, at minimum, delayed. And time will tell if it is to be avoided entirely. Typically, recessions involve significant deterioration in labor

market conditions, but that is certainly not the case currently. At 3.5%, the unemployment rate is holding steady near the lows of this business cycle, and the labor force participation



rate has steadily increased as higher wages encourage more workers to seek employment. This resilience in the labor market has been one of the main drivers of healthy spending despite falling consumer and business confidence along with still elevated inflation. In fact, the Atlanta Federal Reserve is projecting over 2% GDP growth in the first quarter even with the aforementioned headwinds.

On the inflation front, the latest consumer price index (CPI) report showed prices up 5% over the past year. This is still much higher than desired of course, but does represent a meaningful improvement compared to the 9% rate in June of last year. Both durable goods and energy prices have been trending lower, but services and housing have kept inflation well above the Federal Reserve's (Fed) 2% target.

In Europe, it is perhaps what didn't happen that was more important than what did. Heading into the winter months there was legitimate concern that a lack of natural gas could profoundly disrupt its economy and cause hardship for millions of citizens. But timely actions to increase storage capacity, ration demand, and perhaps a little luck with warmer weather, meant that the worst of those potential disruptions didn't occur. While we wouldn't sound the "all clear" just yet, recent data suggests that the economy fared well in the first quarter. Eurozone unemployment is at 6.6%, and both consumer and business confidence steadily improved to start the year. The Euro currency has also strengthened against the U.S. dollar, a sign of investor sentiment towards the region improving.

Japan is in a unique situation amongst developed countries, being one of the few without a real inflation problem. At just

about 3% over the past year, Japanese officials have not had to implement any policies aimed at slowing down the economy. Corporate balance sheets and the financial system also look to be in good shape in our opinion.

The big story in emerging markets is the end of the so-called "Zero-COVID" policies in China. For almost three years, the Chinese economy moved in fits in starts, as the heavy-handed and seemingly haphazard implementation of those policies made it nearly impossible for any sort of sustained economic activity. Given China's size and global trade ties, we think this reopening is another reason Europe's economy has exceeded expectations. There are still issues within China of course, in the housing, property, and construction sectors for example. So, despite the positives that come along with the resumption of a normally functioning economy, outlooks likely need to be tempered.

CENTRAL BANKS

Recent bank failures likely gave the Fed additional pause during their latest meeting in March, but nonetheless moved forward with another 0.25% interest rate increase, bringing the target range for the federal funds rate to between 4.75% - 5%. Inflation is still more than double the Fed's 2% target, and with few signs of deterioration in the labor market, Fed officials likely felt there was cover to proceed with the interest rate hike. In addition to its employment and inflation mandates though, the Fed is also tasked with maintaining the stability and smooth functioning of the financial system. Due to the bank stress, investors now believe the Fed may have to pivot and begin lowering rates later this year.

The European Central Bank (ECB) also increased its key deposit rate in March, but at 3%, it is still meaningfully lower compared to the Fed. Regarding the banking system, in the ECB's opinion, circumstances leading to the takeover of Credit Suisse are not systemic in nature, but rather the result of specific issues with the bank itself.

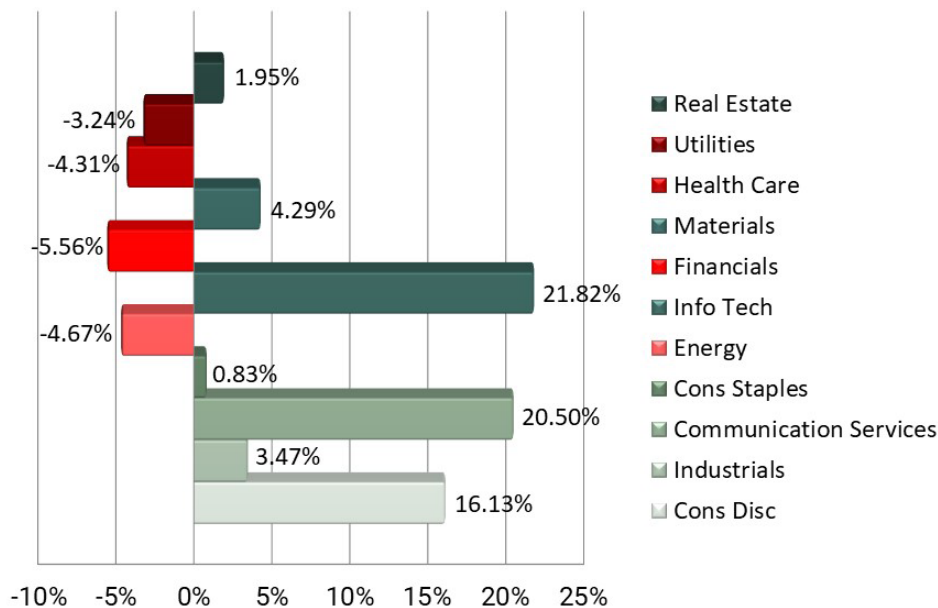
BONDS

A key theme of ours heading into this year was that after an ugly 2022 for bond investors, future returns were likely to be better thanks to higher starting yields across fixed-income markets. It has only been three months, but so far that theme

has proven true. Core investment grade bonds returned 2.96% in the first quarter, aided by a decline in longer-term rates. That longer-term interest rates declined while the Fed was still increasing short-term rates is unusual, and has led to what's referred to as a yield curve inversion, where short rates are generally above long rates. For example, at the end of the quarter, the 3-month Treasury rate was 4.68%, while the 5 and 10-year rates were 3.58% and 3.47%, respectively. Municipal bonds turned in good performance as well, rising 2.78%.

Fixed-income investors also received a boost from sectors outside of the core, investment-grade market. High-yield and emerging market securities, generally considered riskier than traditional core bonds, both delivered near 4% returns in the first quarter.

1Q 2023 S&P 500 Sector Returns



*Past Performance is no guarantee of future results

STOCKS

As we mentioned earlier, stocks maintained their end-of-2022 momentum through the beginning of 2023. In the U.S., the S&P 500 gained 7.50% and broke back above the 4,000 level. That headline return though, masks significant dispersion amongst sectors. It was unlikely a surprise that banks and other financial companies experienced significant selling pressure following the collapse of Silicon Valley Bank. For the first quarter overall, the financial sector was down 5.56%. Energy stocks also struggled amidst volatile oil prices, falling 4.67%. But strong performance from technology and communication services, both of which rose more than 20%, was more than enough to offset those losses. Smaller cap stocks, which tend to have a higher concentration of regional

banks, did lag their larger cap peers but still came through with a 2.74% gain for the quarter.

It has been international stocks though leading the way so far this year, with the MSCI EAFE index of international developed markets rising 8.47%. European stocks seemed priced for a severe recession in October, and with that outcome having been avoided so far both European stock valuations and the Euro currency have been rapidly revalued higher. Also, Japanese equities have performed relatively well and lack the headwind of central bank tightening which can create a challenging environment. The China reopening story will have longer-term implications but hasn't seemed to impact emerging market stock prices yet in 2023. The MSCI Emerging Markets gained a positive but modest 3.96%.

OUTLOOK

The pressing question as we move forward in 2023 is what impact the recent tumult in the banking sector will have on the economy and financial markets. So far, broader, system-wide contagion seems limited. The Fed and government agencies acted quickly to resolve the Silicon Valley Bank failure and implemented a generous new program to provide additional liquidity to banks in need. It is still early, but deposit outflows from regional banks appear to have slowed after a sharp acceleration in mid-March. That said, the quick rise in interest rates will have affected all banks to some degree, and investors are likely to tread carefully in the near future. We also believe that banks are likely to tighten lending standards and focus on balance sheet health, which could lead to slower economic growth.

Fortunately, the global economy does still have some momentum in our opinion. Labor market indicators show little signs of a slowdown, which means consumer spending ought to continue to support the economy. Even with the rise in interest rates, consumer debt obligations relative to income are still very low historically. Also, estimates suggest that there is still near \$1 trillion in excess savings built up during the Covid years, which has boosted spending capacity, though possibly exacerbated the inflation problem as well.

Speaking of inflation, we do believe an ongoing deceleration is likely, though the next leg down from the current 5% rate to something closer to 2% may not be as quick or easy as the decline from 9% to 5%. We think shelter, which is about a one-third weighting in the CPI calculation, is set to ease later this year. Numerous home price indices have fallen for 6 straight months, and real-time rent data from companies like Zillow point to slowing, and in some cases declining, rental rates. This potential deceleration in inflation, combined with the need to maintain financial stability, leads us to believe that the Fed is likely close to the end of its monetary policy tightening cycle.

Overseas, the reopening of China's economy ought to be a significant boost not just to neighboring Asian economies, but to Europe as well, with which it has meaningful trade relationships. We think the momentum in Europe could persist in the short term, but the continent's energy issues are not totally solved. They could crop back up later in the year.

There are a few other issues the market will have to digest this year as well. Domestically, the need to raise the debt

ceiling is one. Historically, the debt ceiling has always eventually been increased, and has had little lasting impact on financial markets. This particular debate is shaping up to be more acrimonious than usual though. Ongoing geopolitical issues, whether it be via trade channels with China or the fallout from Russia's invasion of Ukraine, are present as well.

Heading into this year, we believed the risks of an economic slowdown were higher than usual, and turbulence in the banking system has added to those worries. However, the global economy has proven resilient so far. And following the widespread asset price declines in 2022, both in stocks and bonds, investors are in a more favorable situation with regard to valuations. As always, we will continue to monitor the market environment and attempt to position portfolios appropriately in response.

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