

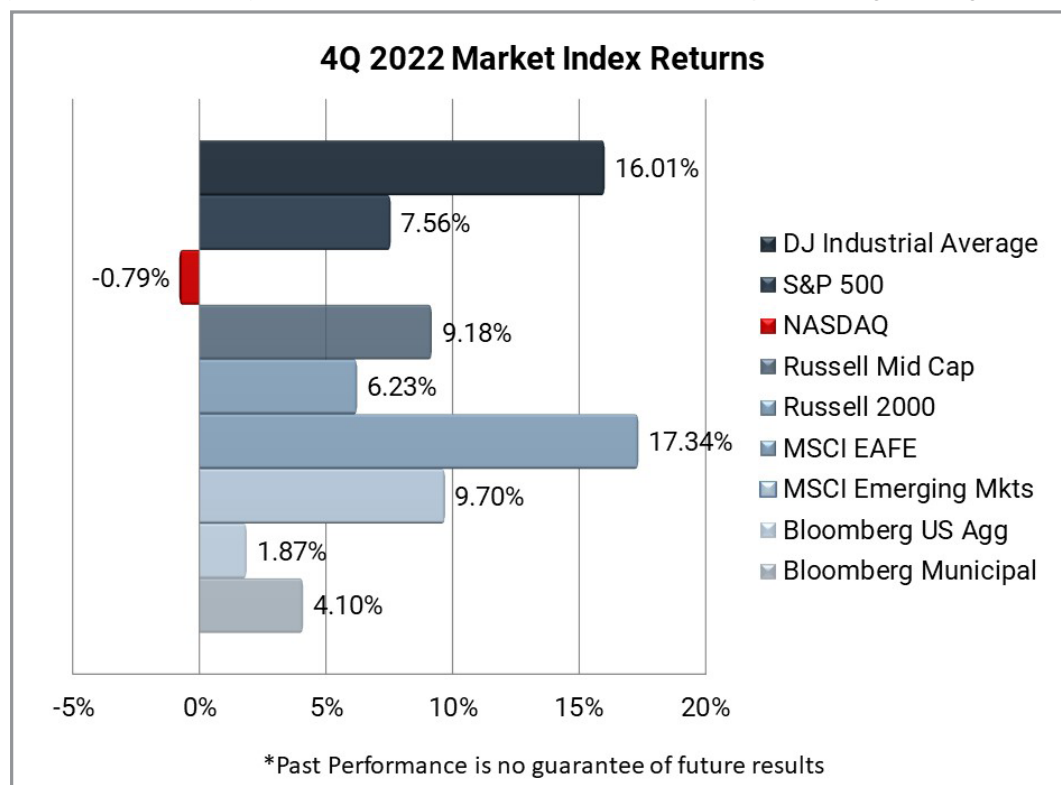
## QUARTERLY MARKET COMMENTARY: *Fourth Quarter 2022*

### *the* ECONOMY

Since 1926, S&P 500 performance has been negative for the calendar year roughly 27% of the time. Call it one out of every four years. Not exactly uncommon, and certainly to be expected for long-term investors. Of course, in this calculation, the mild declines – a roughly 4% loss in 2018, for example – are lumped in with the much larger falls – a 37% collapse in 2008 – so, it doesn't necessarily tell the whole story. Cases like the latter no doubt feel much different than those compared to the former. The causes, and eventual investment implications, typically vary as well. In 2022, S&P 500 returns fell in the middle of that range, down 18.11% for the full year. At one point, the peak-to-trough drawdown had exceeded 25%, but fortunately, a 4th quarter rebound provided a welcome respite to investors.

There are multiple reasons for that rebound, one of which is that the U.S. economy has performed better than anticipated. 2022 started off sluggish at best, with two consecutive quarters of negative GDP growth, meeting a shorthand definition of a

recession. Yet the negative readings were modest, and corporate earnings remained on a positive trajectory. The economy then bounced back in the 3rd quarter, growing



at a 3.2% annual rate, and various Federal Reserve (Fed) estimates suggest we could be in for 3% or better again in the 4th quarter of 2022. All things considered, 2022 is likely to end up a decent year overall for growth. This is consistent with a labor market that still looks to be in good shape to us. We've seen the headlines regarding a number of high-profile firms, especially in technology and technology-adjacent sectors, detailing forthcoming layoffs. While we never like to see job losses; these announcements thus far have not had a big impact on economy-wide data. On average, 247,000 new jobs were added per month over the 4th quarter, and the unemployment rate is back to a cycle low of 3.5%. Any number above 200,000 strikes us as healthy, given that the economy is now in a more mature stage of the business cycle. The labor market is the primary driver of consumer spending, which is the largest component of GDP growth. So, it is no surprise then that this spending was responsible for the pick-up in activity in the second half of the year, despite inflation eating into household budgets.

Speaking of inflation, at 7.1% over the past year based on the Consumer Price Index (CPI), it is still much too high for anyone's liking. Compared to 9% in June though, this is an improvement. Gas prices, often the first thing that comes to mind regarding inflation, have fallen consistently over the second half of 2022, and are, believe it or not, lower today than at the start of 2022. Other components of the CPI, like used cars, are experiencing outright deflation. Home prices have begun to fall as well in recent months, impacted by the surge in mortgage rates. In fact, if there is a notable area of weakness in the economy, it is the housing market. Transaction volume has collapsed as buyers balk at higher

mortgage payments, while sellers are reluctant to lower prices. Construction activity has held up reasonably well, especially for multifamily units, but this industry generally still faces meaningful headwinds.

Overseas, European growth has managed to stay positive but is lagging the U.S. Though not as bad as initially feared, the energy crisis resulting from the Russia/Ukraine conflict has the region's economies in a more precarious position. A recession was just barely avoided in the second half of 2022. Inflation is much too high here as well, but appears to be driven more by energy prices than excess fiscal stimulus, as was the case in the U.S. The silver lining may be that should energy prices cooperate, inflation in Europe could return to an acceptable range more quickly.

Japan's economy continues to slowly improve as tourism returns following the lifting of COVID restrictions. A weaker currency also has put the country's corporate sector, which is already in good shape financially, into a more competitive position.

Due to its size, China is the real swing factor for emerging markets' growth and has an increasingly significant impact on the global economy. Despite what officials say, China was probably in a recession for much of 2022 and is only now starting to emerge from it. Persistent issues in the country's property market and a haphazard "zero-COVID" policy made the year a challenge. Following President Xi securing a third term though, China has done an about-face with respect to the previous COVID policy. It now appears that various restrictions are in the process of being permanently disbanded. It was too late in the year to have a noticeable

effect but represents an important change of course for one of the world's biggest economies.

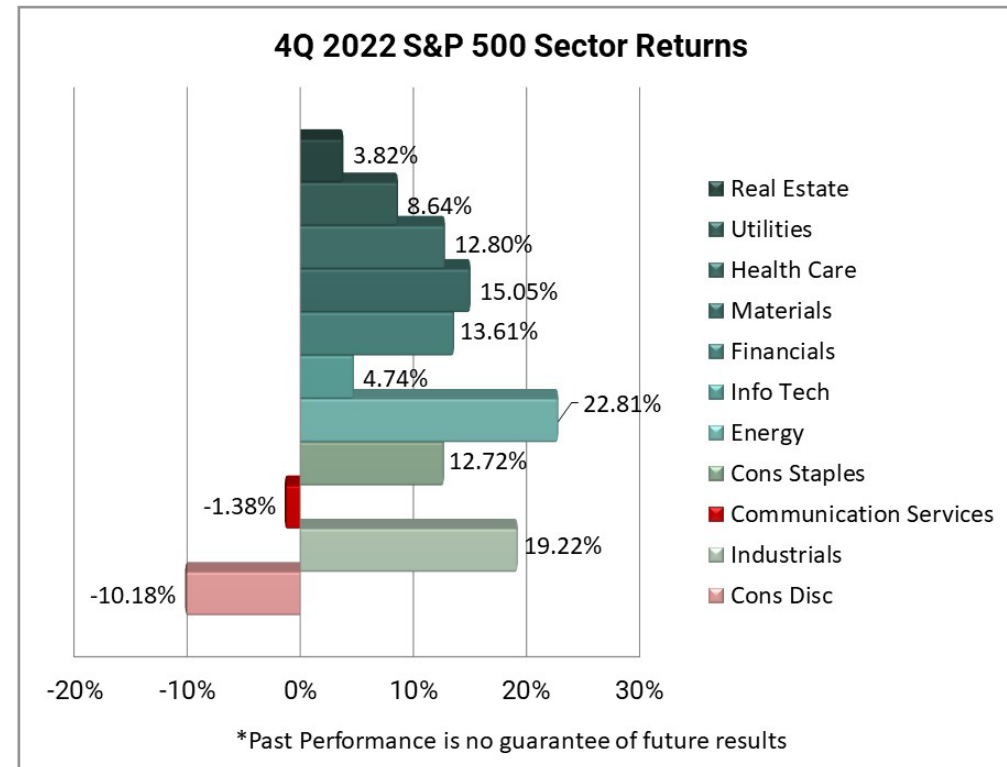
## CENTRAL BANKS

With inflation remaining above levels that the Fed is willing to tolerate, what started out as a mostly ordinary interest rate hiking cycle has morphed into one of the fastest episodes of policy tightening we've ever observed. From 0% at the beginning of 2022, the current target federal funds rate is now between 4.25 – 4.50%, with potentially more to come early in 2023 if Chair Jerome Powell is to be believed. As we mentioned earlier, inflation has been trending in the right direction, but there hasn't been any change in communication from Powell or other members of the Federal Open Market Committee. It seems likely to us then the Fed plans to stay the course in the near future.

The European Central Bank (ECB) and Bank of England (BoE) are following a similar path in raising rates, though have been less aggressive than the Fed. The Bank of Japan (BoJ) had been the lone holdout amongst developed world central banks, but in the 4th quarter also made the decision to allow the target range for longer-term interest rates to drift higher.

## BONDS

Bonds also struggled through the first three quarters of 2022 amidst an unabated rise in global interest rates but did receive a bit of a reprieve in the 4th quarter as that trend slowed down. The 10-year U.S. Treasury yield, for example,



ended the year at 3.88%, justly slightly higher than the 3.80% level at the end of September. This allowed bonds to deliver mostly positive returns from current income generation. The Bloomberg U.S. Aggregate Bond Index, composed of investment-grade government and corporate securities, gained 1.87% over the year's final quarter, breaking a three-quarter streak of negative performance.

Corporate fixed income did especially well to close out the year, which we think speaks to the balance sheet health of large, publicly traded businesses. The environment may be challenging for earnings growth, but bond investors do not see widespread credit risks in markets currently.

In the municipal market, the story is largely the same. Bloomberg's municipal bond benchmark gained 4.10% over the past three months. The full-year losses for municipal bonds mostly reflect an adjustment for higher interest rates, rather than any serious concern about municipal bond quality in our opinion. In fact, state and local tax revenues are, in aggregate, at all-time highs.

## STOCKS

Elevated volatility has characterized much of 2022 for stock market investors, and that remained true in the 4th quarter. Thankfully though, it was the "good" kind of volatility – to the upside – with the S&P 500 gaining 7.56%. Leading the way, as it has done for most of last year, was the energy sector, which rose 22.81%. Lagging sectors included communication services, down 1.38%, and consumer discretionary, down 10.18%. But it is worth noting that a single stock, Tesla, is technically categorized as a consumer stock and represents a relatively large portion of the group based on market cap. So, the fact that consumer stocks were lower is, in this case, more a reflection of the poor performance of a single security, rather than an indication of weak consumer spending in our opinion.

International equities rallied as well, and to an appreciably greater extent than their U.S. peers. The MSCI EAFE Index rose 17.34%, led by European shares which were up over 20%. Given that Europe is at the epicenter of the Russia/Ukraine conflict, it is perhaps not immediately clear why performance has been strong recently. It is, of course, just one quarter, too short a time period to declare a new trend in place. But

we do think there are a number of factors influencing that performance that are worth monitoring. First is valuations. The price of many European stocks relative to their profits was at very low levels, often levels not seen since the financial crisis in 2008. In those environments, seemingly small improvements in fundamentals can lead to sharp price moves. Second is a weakening dollar. As the Fed had slowed down interest rate hikes, the Euro has appreciated versus the U.S. dollar, boosting European stocks returns. And third, is the aforementioned lifting of restrictions on China's economy. European companies, as well as those in Japan and Australia, tend to be more reliant on exports for growth, a significant amount of which are sold to China.

We also do want to note the continued relative outperformance of value shares versus their growth counterparts, a trend that began to take hold in 2021. In the 4th quarter, global value stocks increased 14.21% against a 5.28% rise for growth.

## OUTLOOK

As our Investment Committee sat down to review 2022 and discuss the outlook for 2023, we discussed a few key themes that we think will influence the direction of markets.

The first of which is the potential for a more pronounced economic slowdown. Developed world economies have been resilient, and may remain so, but certain indicators look more worrisome and are worth monitoring. For instance, though we haven't seen much change in behavior from consumers and businesses, confidence surveys from both are at levels generally associated with recessionary environments. And overseas especially, elevated energy prices are still taking

a toll on economic activity. That said, if China continues to quickly reopen, it represents a real upside catalyst. China's economy is so large and interconnected, that stronger growth there will have positive knock-on effects around the world. Also, global central banks spent last year meaningfully tightening monetary policy though. We know that these policy moves act with lag, so their full impact likely won't be felt until this upcoming year and beyond. It's important to remember though, that stock markets are forward-looking, so the potential weakness in 2023 is already at least partially reflected in current prices, leaving room to exceed expectations.

On inflation, we expect considerable deceleration throughout 2023. We see mounting evidence of this throughout the global economy. And while we don't know that inflation will fall back to central banks' 2% target by year-end, progress should be made. An array of inflation expectations from consumers, professional forecasters, and real-money investors all point to inflation averaging less than 3% per year for the next 5 years.

Taking into account our view of decelerating inflation, combined with the rise in interest rates, leaves us with a generally more favorable view of bonds. It has been challenging to generate both income and total return from these securities in recent memory as central banks insisted on holding interest rates at historically low levels. That should change going forward and diversified portfolios can expect a bigger contribution to return and more diversification benefits from their safer fixed-income investments.

A few other issues we're keeping an eye on include the

changing political landscape here in the U.S. and ongoing geopolitical conflicts overseas.

In summary, the outlook for this year may be cloudier than we're used to, but the price declines for both stocks and bonds in 2022 leave us with, in our opinion, a more constructive setup for long-term investors. Years like this past one remind us more than ever of the importance of a disciplined approach and adherence to a well thought out plan. As always, we will continue to monitor the market environment and attempt to position portfolios appropriately in response.

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