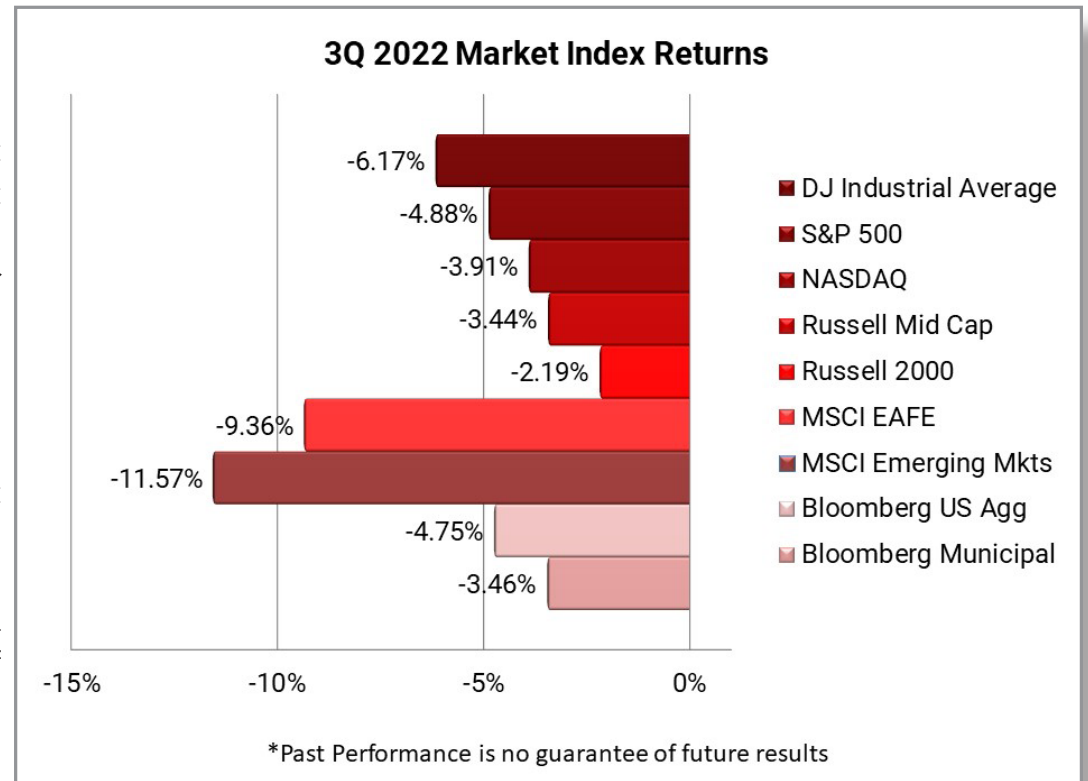


QUARTERLY MARKET COMMENTARY: *Third Quarter 2022*

the ECONOMY

Market corrections, and even outright bear markets, are nothing new for seasoned stock investors. Managing an investment portfolio is about balancing risk and reward, and these types of drawdowns represent the risk in that calculation. It's the price we pay for the reward of higher compounded returns over the long-term. Yet, compared to more recent periods of poor market performance, 2022 has taken on a distinctly different character. For comparison, S&P 500 bear markets in 2018, down 21%, and 2020, down 35%, were similar if not worse in magnitude relative to where we are today. Each of those however were, fortunately, brief, with peak to trough declines lasting less than 3 months, and quickly followed by robust recoveries. This year though, we are close to 9 months of market malaise, replete with elevated volatility, continued uncertainty, and a general sense of unease. This is perhaps not surprising given the current geopolitical environment and persistent inflation, but the state of the economy and global markets may not be as dire as news headlines would have you believe.

In the U.S., if we're to use the shorthand classification of a recession – two straight quarters of negative GDP growth – then we lived through one in the first half of 2022. Other,



more comprehensive explanations would suggest otherwise, but quibbling over definitions misses the forest for the trees. The short story is that the economic momentum from 2021 petered out early in 2022. But it does appear that activity picked back up in the third quarter, with the Atlanta Federal Reserve estimating GDP to come in at close to a 3% rate. With the ongoing strength in the labor market as well as consumer spending, especially in service industries, that seems reasonable to us. In fact, on average over 350,000 jobs per month have been added so far this year, and the unemployment rate is holding steady at a cycle low of 3.5%. Not exactly recessionary. Also, high frequency spending data belie recessionary fears, at least for the time being. Whether its reservations for dining out, air travel passengers, or hotel occupancy, all are back to, if not above, pre-covid levels. This isn't the type of behavior we would typically see if people were expecting a major downturn in the economy.

To be sure, ongoing high inflation has certainly tightened budgets for many, and cash cushions built up during Covid-related lockdowns are beginning to dwindle. At last check, the consumer price index (CPI), the most common measure of inflation, was up 8.1% over the past year. Consumer spending at current levels isn't sustainable if that number doesn't come down going forward. Fortunately, gas prices have fallen for three months straight, and a number of other goods including used cars and home furnishings, as well as airfares, have declined recently as well. On the other hand, food prices, which are being impacted as much by labor shortages as they are from the underlying commodity, as well as housing costs, have remained stubbornly high. Speaking of housing, if there is a major area of weakness in

the economy, this is it. Surging prices over the past 2 years combined with a rapid rise in mortgage rates has caused a significant slowdown in the residential real estate market. Potential buyers are balking at mortgage rates and sellers are reluctant to accept discounted offers. That said, while the transaction market is at a standstill, new building is continuing at a rapid pace. There are currently more single and multi-family units under construction today that there have been in four decades.

The European Union (E.U.) economy in aggregate managed to outperform the U.S. in the first half of the year, at least based on official GDP statistics. But we don't believe that its actually in better shape currently. Due to the E.U.'s proximity to the Russia/Ukraine conflict, as well as many of its member countries' reliance on imported fossil fuels from Russia, energy costs have become a major issue. In response, governments have instituted various policies aimed at capping those costs for households and businesses. And while this may provide a much-needed reprieve, the policies are new, untested, and likely not a long-term solution. Despite these headwinds, there hasn't been any clear negative impact on the labor market. The E.U.-wide unemployment rate is at an all-time low of 6%. Retail sales have been flat for most of the year though, suggesting that energy costs are impacting consumer behavior.

Japan's domestic economy may actually be improving somewhat, as it has taken longer for the country to fully lift Covid protocols. Travel both within Japan and from outside the country is poised to become significantly less burdensome. Also, Japanese corporations are awash in cash, which isn't a bad position to be in as interest rates on new debt have been

rising rapidly. Australia as well seems to have managed the first half of the year rather well. Rebounding global trade and higher commodity prices have supported the country's economy.

As large as China's economy has become, it tends to be the swing factor in emerging markets growth, at least in Asia. Despite what official figures say, China was probably in a recession earlier in 2022, and is only now struggling to fully emerge from it. Issues in the property market as well as a haphazard Covid policy have thus far throttled any sustained recovery though. To that end, Chinese policy makers have gone in a different direction compared to developed world peers, generally easing monetary policy and providing additional fiscal stimulus, hoping to boost growth. Latin America economies and markets have fared relatively well this year, as they are often more reliant on commodity production, so higher inflation can actually be a benefit in some respects.

CENTRAL BANKS

With inflation remaining above levels that the Federal Reserve (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. Starting at 0% at the beginning of the year, consensus projections for the federal funds rate now hover around 4.5% by the time 2023 rolls around. Despite the ostensible dual mandate of stable prices and full employment, the Fed seems to have zig zagged from one to the other over the past 2 years. In 2021 the view from Chair Jerome Powell and the rest of the

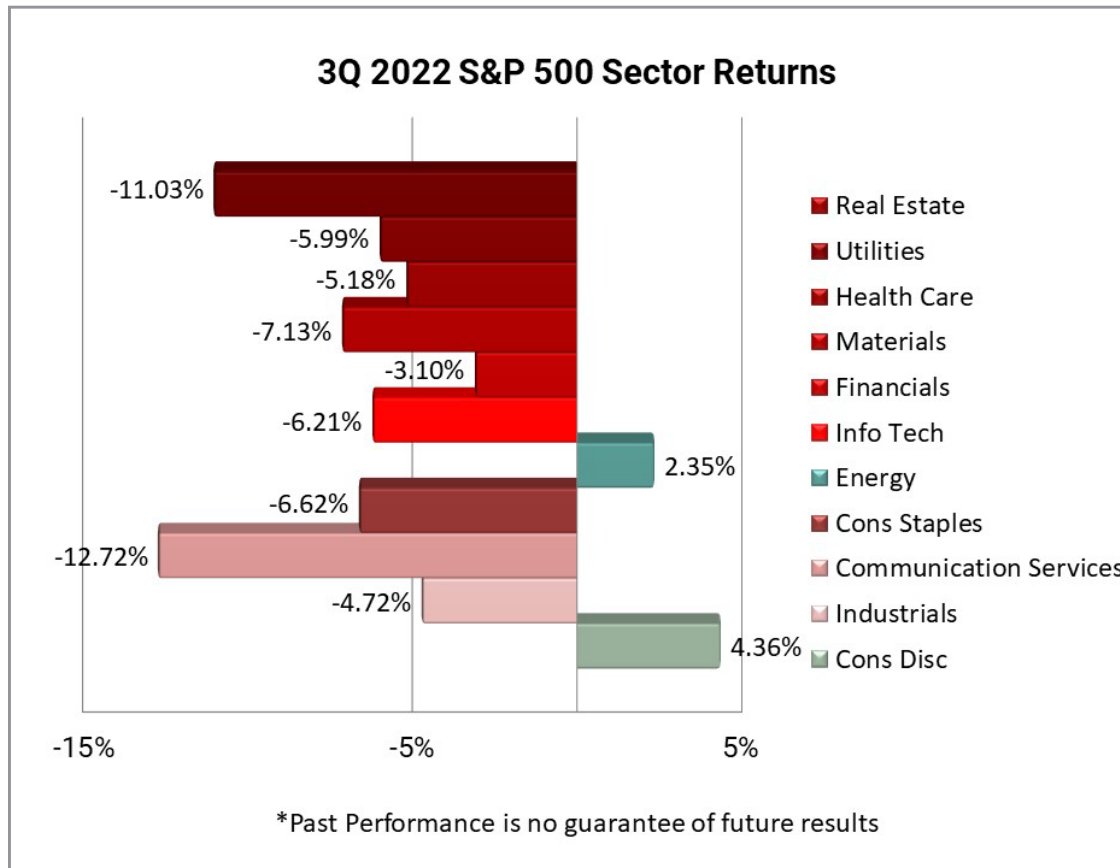
Federal Open Market Committee (FOMC) was that the labor market recovery was paramount, and we should be willing to accept somewhat higher inflation to reach that goal. Today, the opposite is true. Reigning in inflation takes precedence even at the potential expense of future employment. It has been challenging interpreting the different, sometimes contradictory, communications coming from various FOMC members this year. But we will take Chair Powell at his word when he says that he believes policy will need to be restrictive for some time before the FOMC is comfortable that inflation has truly subsided.

The European Central Bank (ECB) and Bank of England (BoE) are following a similar path in raising rates, though should be less aggressive than the Fed. Inflation in Europe has been driven more by soaring energy prices, which central banks have little control over, rather than excessive consumer demand. The Bank of Japan (BoJ) appears to be the lone holdout, still committed to maintaining a low interest rate regime.

BONDS

The global rise in interest rates continued unabated for the third quarter in a row, putting further downward pressure on bond prices. In the U.S., the benchmark 10-year Treasury yield rose from 2.89% at the start of July, to 3.80% by September's end. Similar rises were experienced throughout Europe and Australia. As we mentioned earlier, in the developed world only Japan has committed to keeping a lid on interest rates.

Typically, staid investments, bond market volatility has been unusually elevated this year compared to historical norms



due to the movement in interest rates. That isn't to say that bonds have failed to provide any cushion against falling stock prices, they have provided some. It's just not near as much as investors have come to expect. The Bloomberg US Aggregate Bond Index, composed of highly rated government and corporate issues, fell 4.75% over the third quarter. Interestingly, high yield bonds, which are considered riskier than their investment grade counterparts, were down only 0.68%. We often see these types of riskier securities underperform during periods of uncertainty or economic

weakness, but that's not the case today.

One reason that for the relative steadiness of high yield bonds in our opinion, is that corporate balance sheets overall look to be in good shape. The current environment may present a challenge to earnings growth, but fixed income investors don't see widespread default risk in credit markets presently.

In the municipal market, the story is largely the same. Bloomberg's municipal bond benchmark fell 3.46% over the past three months but was mostly reflecting an adjustment for higher interest rates, rather than any serious concern about municipal bond quality. In fact, state and local tax revenues are, in aggregate, at all-time highs.

STOCKS

Over the third quarter, the S&P 500 fell 4.88%.

Certainly not what investors like to see, but historically that's a relatively mild quarterly drawdown. But it certainly didn't feel mild. After rallying nearly 17% off of its June lows through early August, U.S. large cap stocks then proceeded to fall over 19% through quarter end. So that headline 4.88% loss masked significant underlying volatility. From a sector perspective, the leadership profile in the third quarter is similar to what we've experienced all year. Energy was again the top performer, while communication services and technology, which tend to have more highly valued, faster growing stocks, were the laggards. Small cap stocks

actually outperformed their large cap peers, which is not always expected during periods of uncertainty. The Russell 2000 Index fell just 2.19% in the third quarter. Small caps have the benefit of generally being more insulated from global events compared to large caps, which may be part of the explanation.

After outperforming over the second quarter, international stocks gave most of that back and then some in the third. International developed and emerging market equities were off 9.36% and 11.57%, respectively. China and Germany have led the way down internationally. China largely due to its stop and start reopening policy, while Germany is most reliant on shrinking gas imports from Russia. We'd also be remiss not to mention the impact of a stronger dollar on international returns. Without the currency impact, international stocks are actually faring much better than U.S. ones this year. But the flight to safety has driven up the exchange rate of the U.S. dollar, reducing the returns U.S. investors receive on international investments.

Also, important to note is that despite the losses in stocks this year, corporate earnings have still been increasing. Share buybacks and dividend payouts are likely to be at or near record highs through the third quarter. So, most of the fall in stocks has been due to a contraction in valuation multiples, rather than any material earnings decline. The free cash flow yield on U.S. and international stocks is now 5.40% and 11.10%, respectively, much better compared to the start of the year.

OUTLOOK

We noted last quarter that our forecasts for economic growth and asset returns had to be ratcheted downward in response to an increasingly uncertain environment. As we move towards the end of the year, the outlook hasn't become any clearer. While the risks surrounding the Russia/Ukraine conflict are now generally "known", the ultimate impact, especially on energy prices longer-term, is still undetermined.

In the U.S., it does look like there will be a modest rebound in economic growth to close out the year. The labor market remains in good shape, which should support consumer spending. And there is still a savings cushion built up that can help people make it through this period of high inflation. Inflation has persisted for longer than many anticipated, but we do see signs that it will cool in the months to come. The CPI is a lagging indicator, and when we look at more real-time data, we already see signs of that cooling. For example, both home prices and apartment rents have fallen over the past two months, but this will take time to show up in the official reports. These two components make up nearly one third of CPI, so are crucial for inflation to be brought back under control. Gas prices have ticked up a bit recently but are still well below highs from June. Also, since CPI is a backward-looking measure, it's very important to also focus on expectations for the future. Market-based measures are calling for inflation of just 2.32% annually over the next 5 years, and consumer expectations are just barely higher. There is no guarantee that these measures will prove correct of course, but there doesn't seem to be any evidence

of an entrenched inflationary mindset amongst investors or consumers. That said, we do think that since the Fed is hyper-focused on the monthly inflation reports, we don't anticipate a material change in monetary policy until that data is more to their liking. We mentioned earlier that service sectors of the economy are trending in the right direction, and we don't see a near-term reason for that to slowdown meaningfully.

A few other things we're keeping an eye on include, of course, the geopolitical situation in Europe, as well as U.S.-China relations. It's also a midterm election year, which have historically been more challenging for markets. We see the two most likely outcomes as Republicans taking the House and Democrats keeping the Senate, or Republicans winning both. In either outcome, the policy implications are likely very similar. The Biden agenda probably comes to a halt.

Regarding financial markets, in bear market periods its natural to think back to the worst of them and wonder if this time will be similar. And while we can't rule out further volatility, the economy is in a much better state today, compared to 2007 and 2008 prior to the financial crisis. Both consumer and corporate balance sheets are in healthy, which limits the potential for underlying systemic issues of the type that preceded the financial crisis. Looking forward, because bond yields have risen so quickly, the outlook for returns in fixed income securities is as favorable as it's been in years. Stock market valuations are also pricing in a fair bit of bad news, and are looking more attractive.

We find it's important, particularly during these more volatile periods, to remind ourselves that market drawdowns are inevitable, and that successful long-term investing requires

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.

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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