

LUTHER KING CAPITAL MANAGEMENT

2022 REVIEW

Following two tumultuous years, the global economy entered 2022 with what appeared to be new strength. Inflation was accelerating, but markets expected the Federal Reserve to raise its benchmark interest rate by a modest amount over the course of the year to help bring inflation down. The decision by Russia to invade Ukraine on February 24th sent shockwaves through global markets as the price of gold, wheat, crude oil, and natural gas soared. By the end of the first quarter economic momentum was waning under the weight of the Ukrainian invasion, persistent inflation, and the emergence of the Omicron variant which closed the world's largest container port in Shanghai, among other disruptive effects.

Gross Domestic Product (GDP) readings for the first half of 2022 suggested that the economy was either in a recession, or on the cusp of one. Real GDP declined at an annual rate of 1.6% and 0.6% in the first and second quarters of 2022. In contrast, the economy lifted in the third quarter, expanding 3.2% with the fourth quarter anticipated to reflect similar growth. A narrowing trade deficit, increases in consumer spending, and government outlays drove this reversal. This environment of negative GDP growth without a recession is very rare.

There has only been one other episode in the post-World War II period in which two consecutive quarters of negative real GDP were not associated with a recession – the second and third quarters of 1947, as the economy was adjusting to the post war era. Employment expanded, and the unemployment rate averaged 3.6% in 1947, similar to the current tight labor market. The official recession dating organization, the National Bureau of Economic Research, has not yet labeled the first half of 2022 a recession and is unlikely to do so in our opinion because the period did not fully exhibit the breadth of economic softness associated with a recession. For example, gross domestic income and robust job growth in the first half of the year were inconsistent with recessionary conditions.

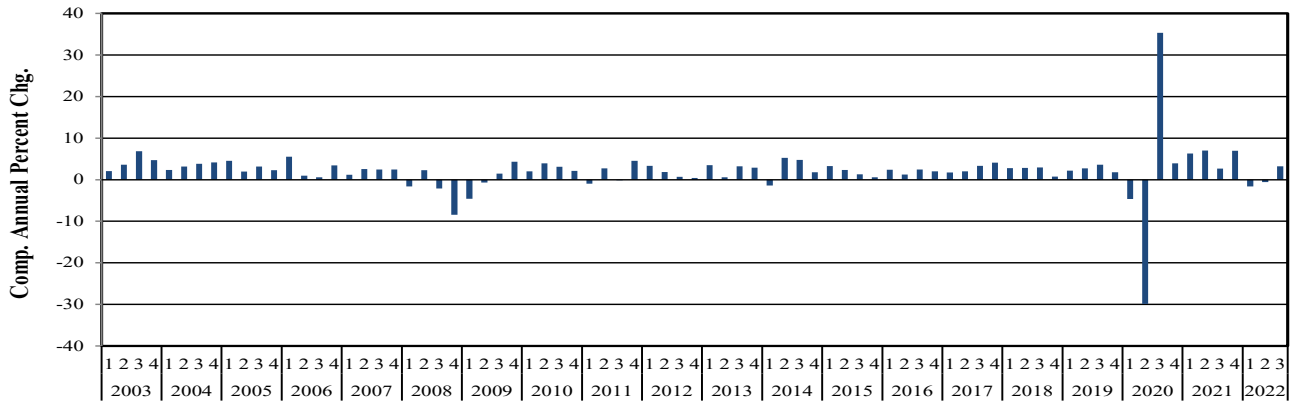
In June, inflation as measured by the Consumer Price Index reached a high of 9.1%, reminiscent of the late 1970's and early 1980's. Following a 0.25% interest rate hike in March and a 0.50% increase in May, the central bank raised its benchmark rate by three quarters of a percent in June. Federal Reserve Chair Jerome Powell put it best in late June when he said, "I think we now understand better how little we understand about inflation." In the final nine months of 2022, the central bank raised its benchmark rate by 4.25%, the largest calendar year increase since 1973. We have twice witnessed more rapid tightening, and it did not end well for the economy in either instance. During the 1979-1980 period, the Volcker-led Federal Reserve increased its benchmark rate from 11.5% in October 1979 to 20.0% by March 1980, or 8.5% in just six months. Following a short period of easing, the Federal Reserve once again had to tighten monetary policy, moving its benchmark rate from 9.5% in August 1980 to 20.0% by that December. A recession ensued in both episodes of sharp tightening, although this action was necessary to subdue double-digit inflation expectations at the time. The success, though painful, set-up an extraordinary period of positive returns in both the equity and bond markets.

The Federal Reserve's hawkish stance during 2022 had a profound impact on the bond market and the U.S. dollar. The 2-Year Treasury note, which is very sensitive to shifts in monetary policy, rose nearly 4.00% to a peak of 4.72% in early November before settling back to 4.43% at year-end. While inflation inherently erodes the purchasing power of a dollar, in nominal terms the U.S. dollar strengthened dramatically in 2022 versus our major trading partners. The result is an earnings headwind for U.S. multinational companies that generate significant international earnings. This headwind should ease in the coming year, as central banks and governments around the world hiked interest rates and conducted foreign exchange interventions to increase the value of their own currencies relative to the U.S. dollar.

2022 was a bruising year for the capital markets. Stock and bond prices fell in unison as the Federal Reserve battled inflation. Long-dated bonds fared the worst with the price of the 30-Year Treasury bond falling 33.4%. The Standard & Poor's 500 Index handed in its worst performance since 2008, declining 18.1%, with only two of the eleven sectors of the market, Energy and Utilities, finishing with positive returns. The equity market internals were also very dramatic, with value stocks outperforming growth stocks by the second widest margin since 1979. The technology-laden NASDAQ Composite Index, which had dominated the stock market leadership since the market recovery began in May 2020, fell 32.5% in 2022.

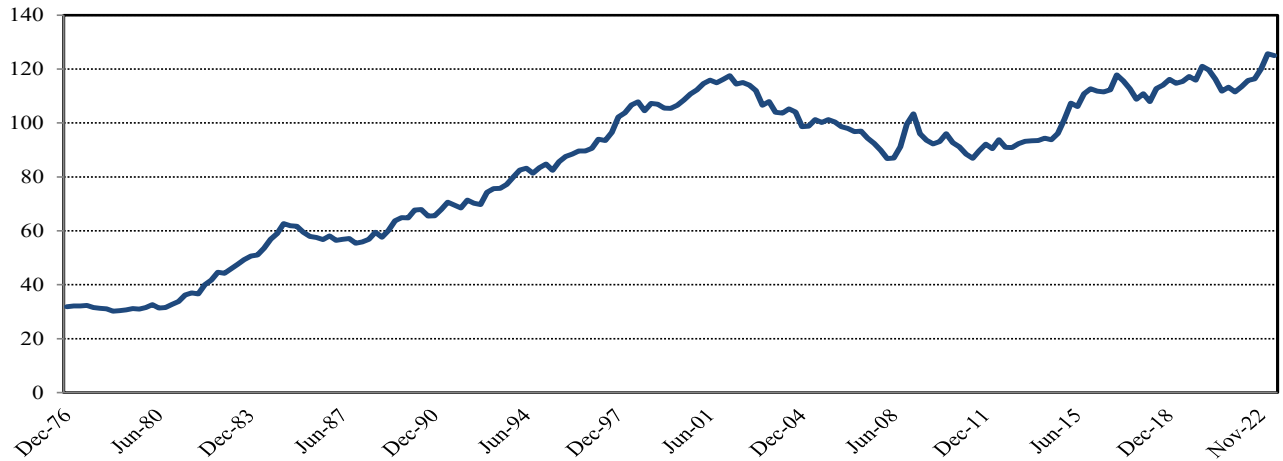
As we have in prior fourth quarter reviews, we have included a compendium of economic and market related charts.

Real Gross Domestic Product



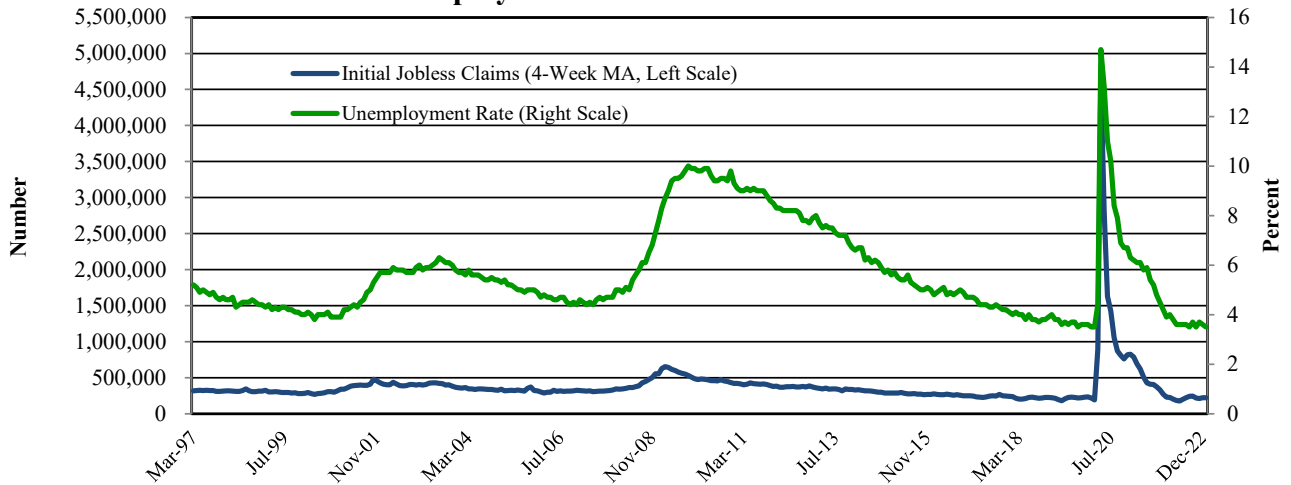
Source: U.S. Department of Commerce: Bureau of Economic Analysis

U.S. Federal Reserve Trade Weighted Nominal Broad Dollar Index



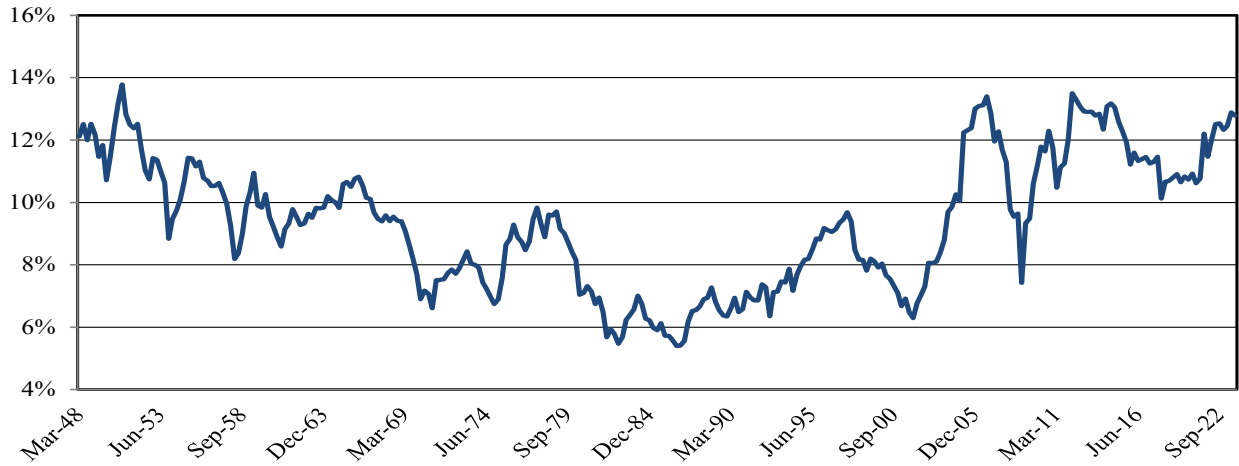
Source: Federal Reserve

Unemployment Rate & Initial Jobless Claims



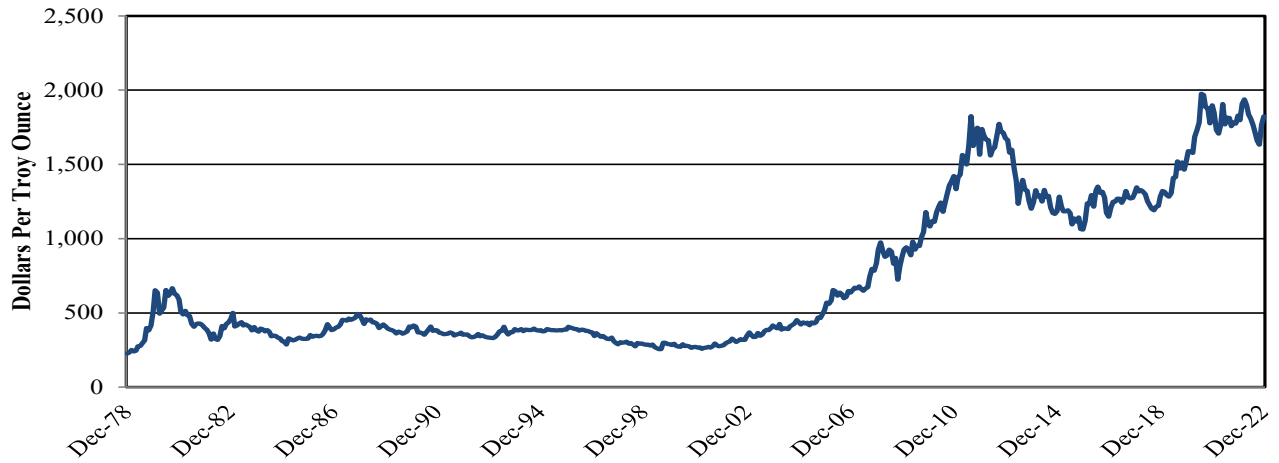
Source: U.S. Department of Labor: Employment and Training Administration/U.S. Department of Labor: Bureau of Labor Statistics

Corporate Profits as a Share of Gross Domestic Product



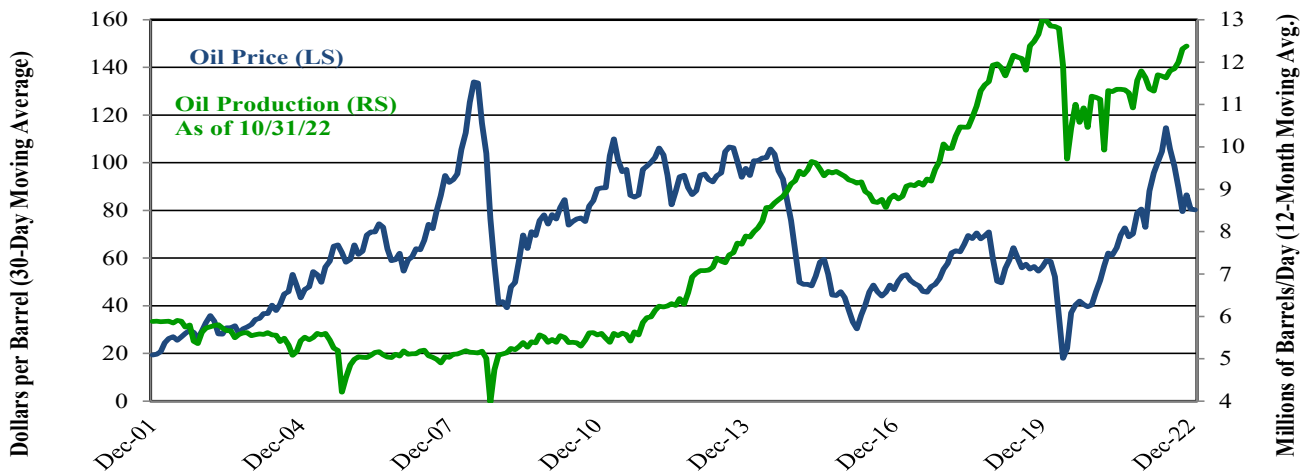
Source: U.S. Department of Commerce: Bureau of Economic Analysis

Price of Gold



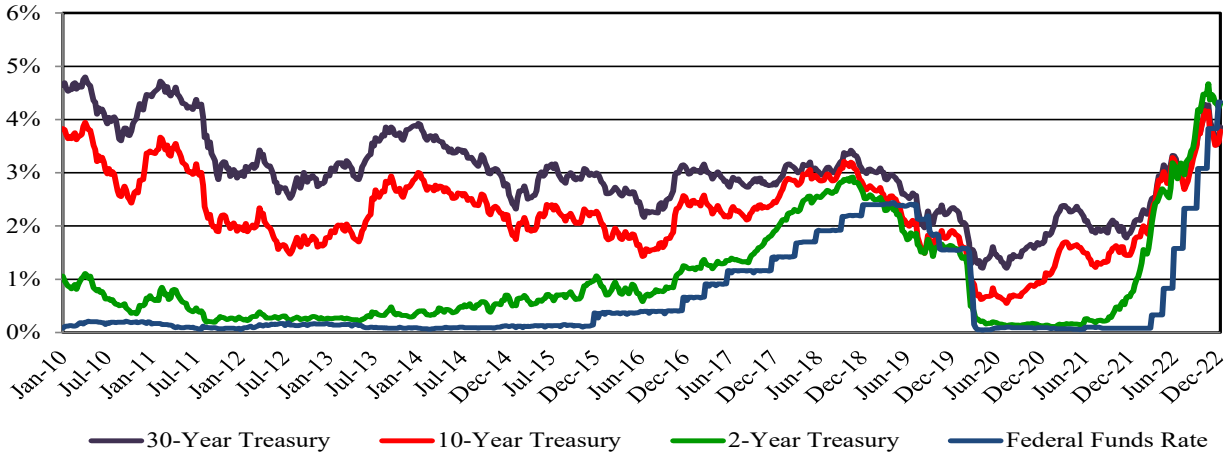
Source: Bloomberg

U.S. Oil Production & Spot Oil Price: West Texas Intermediate



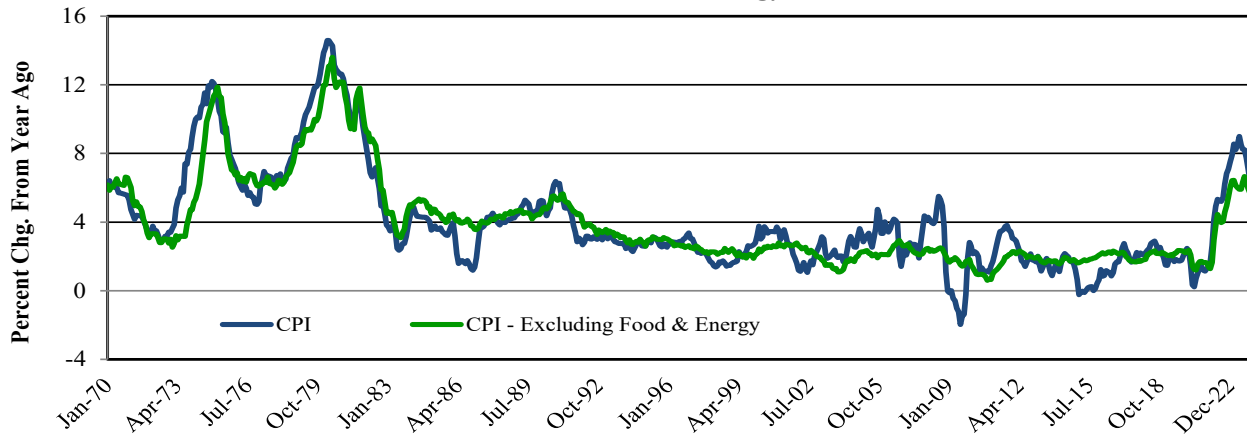
Source: Dow Jones & Company/Department of Energy

U.S. Treasury Rates & Federal Funds Rate



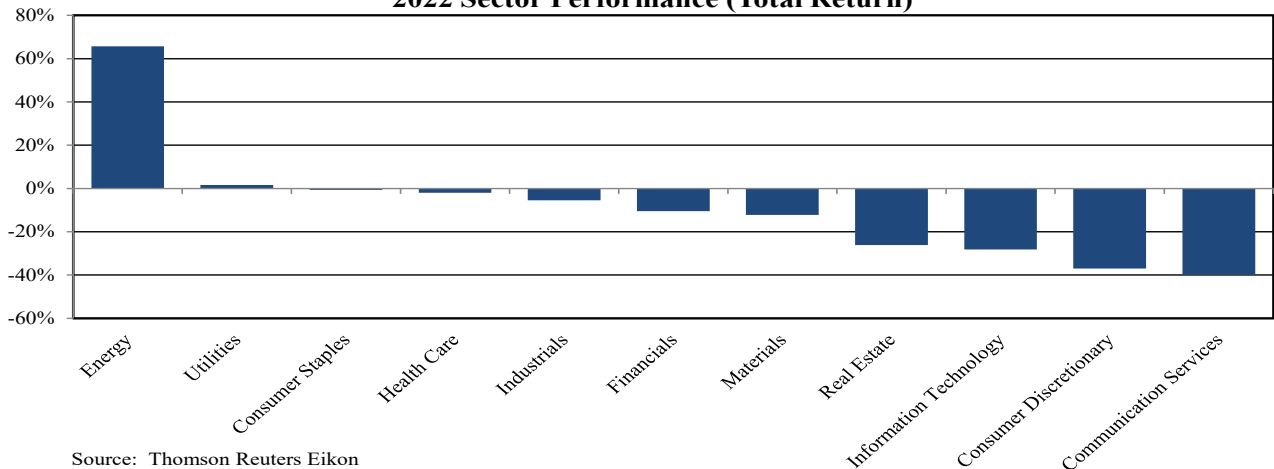
Source: Board of Governors of the Federal Reserve System

Consumer Price Index for All Urban Consumers: All Items Consumer Price Index for All Urban Consumers: All Items Less Food & Energy



Source: U.S. Department of Labor: Bureau of Labor Statistics

Standard & Poor's 500 Index 2022 Sector Performance (Total Return)



Source: Thomson Reuters Eikon

2023 OUTLOOK

The new year is likely to be worse for the economy, but better for the markets.

The economy continues to pass successive signposts that suggest the ultimate destination is a recession. A deeply inverted yield curve, cascading Leading Economic Indicators, and a sharp decline in housing activity have all historically portended a recession. There are still some signposts potentially just over the horizon that would cement our recession outlook, including a meaningful increase in the half century low unemployment rate of 3.5%.

Much of what the economy will be digesting in the year ahead is the substantial monetary tightening that occurred in the previous nine months. The time lag between changes in monetary policy and its impact on the real economy is roughly one year. So, the brunt of last year's monetary tightening still lies ahead for the economy. Higher interest rates work through two primary channels. First, higher interest rates stifle areas of the economy that are most sensitive to changes in the cost of borrowing, such as housing, auto sales, and business capital spending. Second, the decline in demand for goods in the interest rate sensitive parts of the economy results in lower wages for workers in those industries, and other workers lose their jobs entirely.

The potential recession has been labeled the most anticipated recession in memory, but several factors are pushing out its onset. First, job openings remain elevated with 1.7 job openings per unemployed worker, nearly 50% higher than December 2019. The ability of workers to quickly find new employment opportunities pushes wages higher and keeps the unemployment rate low. Second, after contracting for five sequential quarters, aggregate real disposable personal income rebounded in the third quarter – and likely continued in the fourth quarter. Historically, it is highly unusual for real wages to decline when unemployment is this low. As inflation continues to fall, real wage growth should remain positive, even if nominal wage growth decelerates. Finally, households remain flush with savings, despite declines in the savings rates and increase in consumer credit balances.

If a recession does arrive, it will likely be mild. We would characterize the nature of a recession in 2023 as being an “earnings” recession rather than a “balance sheet” recession, which is an important distinction. The Great Financial Crisis that began in 2007 was a recession during which severe damage occurred to both household and business balance sheets. That adverse environment forced individuals and businesses to save more while consuming and investing less in order to deleverage. That period demonstrates the

economy historically contracts more in balance sheet recessions and takes longer for growth to reemerge, in part because credit creation is slow to rebound. In contrast, earnings recessions are typically shallower in nature as the economic damage is less pervasive.

There is a case for avoiding a recession in the coming year, but it will require the labor market, consumer spending, and the central bank to each strike the right balance in order to achieve an economic “soft landing.” In our view, the labor market is now the most important factor in shaping the Federal Reserve’s deliberations over interest rate policy in the coming year. The annual pace of consumer inflation as measured by the Consumer Price Index, has fallen each month since its June peak of 9.1%. The downward trajectory is partially attributable to deflation in the price of goods, helped by easing supply constraints and a shift in spending towards services. Further, the shelter component of services currently puts upward pressure on inflation.

Falling goods prices and an eventual roll-over in shelter prices should push inflation lower still in the coming year. However, there is considerable risk that inflation readings settle uncomfortably short of the Federal Reserve’s stated 2.0% target. To narrow this gap from 4.0 - 5.0% inflation to 2.0% would require the upward pressure on services prices, other than housing, to ease. Unfortunately, achieving this critical step will likely require bringing the supply and demand for labor back into balance.

Retirements have surged while the U.S. population aged, and fewer young people are joining the workforce. During 2022, the economy saw the second-most jobs added in a calendar year behind only 2021. Clearly the labor force has expanded over time. Nevertheless, the jobs added in 2021 and 2022 relative to the working age population were both near 30-year highs. The labor force is now almost identical to the size it was the month before the pandemic began, whereas the total population is around five million greater. This dynamic is reflective of the enormous tightness in the current labor market.

We are more optimistic on the markets than the economy. The entire decline in the Standard & Poor’s 500 Index in 2022 was attributable to the compression of the Price/Earnings ratio, as corporate earnings likely expanded between 4.0% - 5.0% for the year, the estimate LKCM was using in January 2022. The Price/Earnings ratio fell last year in response to higher interest rates, wider credit spreads, and recession fears. The year ahead has the potential to be the inverse of 2022. We expect corporate earnings to decline in 2023, while the Price/Earnings ratio may ultimately expand as credit spreads begin to normalize. It is not unusual for the stock market to begin to move higher roughly a year before corporate earnings bottom. Finally, it is rare for the Standard & Poor’s 500 Index to post consecutive years of negative returns. In

the intervening seventy-seven years since the end of World War II, the market recorded negative returns in twenty-one of those years. In only three instances (1973-74, 2000-01, 2001-02) has the market declined in successive years. Taken as a whole, we anticipate a more favorable market environment in 2023 as prices begin to discount future earnings on better outlooks for interest rates and credit spreads.

The risks to our outlook are greater than normal for several reasons. Geopolitical tensions with Russia and China are well known, but unresolved. Domestically, the recent Speaker of the House of Representatives process could be prelude to debt ceiling bargaining that will need to take place in 2023. As aggregate demand softens in the face of last year's monetary tightening, we believe corporate operating margins could compress and weigh on corporate earnings. Volatility may remain high, and the economy will likely enter a recession in the coming year, or only narrowly avoid one. Investors will overweight near-term economic data in an attempt to discern when the Federal Reserve is likely to end the current tightening cycle and perhaps lower interest rates to support future economic growth. Despite these downside risks, the equity market should trend higher during the year in our view.

FINANCIAL MARKET TOTAL RETURN*

	Fourth Quarter 2022	Six Months Ending 12/31/22	One Year Ending 12/31/22	Annualized Return Two Years Ending 12/31/22	Annualized Return Three Years Ending 12/31/22	Annualized Return Five Years Ending 12/31/22
Standard & Poor's 500 Index	7.56%	2.31%	(18.11%)	2.66%	7.66%	9.42%
Russell 2000 Index	6.23%	3.91%	(20.44%)	(4.42%)	3.10%	4.13%
Value Line Composite Index	9.64%	3.26%	(18.53%)	(0.92%)	1.04%	1.07%
Dow Jones Industrial Average	16.01%	8.85%	(6.86%)	6.13%	7.32%	8.38%
NASDAQ (OTC) Composite	(0.78%)	(4.65%)	(32.51%)	(9.19%)	6.16%	9.70%
Bloomberg Gov't/Credit Intermediate Bond Index	1.54%	(1.57%)	(8.23%)	(4.90%)	(1.26%)	0.73%

* Total Return Includes Income

Michael C. Yeager, CFA
January 9, 2023

IMPORTANT INFORMATION

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