LUTHER KING CAPITAL MANAGEMENT

FIRST QUARTER 2023 REVIEW

We anticipate a slowdown will ripple through the economy as the year continues to unfold. The current level of Treasury yield curve inversions, falling Leading Economic Indicators, and tightening bank standards have historically been associated with the economy being in, or very near, a recession. The key to the "recession question" will likely hinge on the health of the labor market. A half century low unemployment rate and strong wage growth continue to present a challenge to the Federal Reserve's 2.0% inflation target. If the central bank believes it must continue to tighten monetary policy to quell wage pressure, it will leave the economy increasingly vulnerable to a recession.

The monetary tightening cycle has reached the beginning of the end, in our view. The Federal Reserve may yet raise interest rates another quarter of one percent, but signals from the bond market suggest the central bank could begin cutting interest rates as early as later this year. It is important to recall that the central bank's first interest rate hike was not until March 16th of last year. The Federal Reserve has marched up its benchmark rate by 4.75% in slightly over twelve months. Despite speculation that the economy may be somewhat less interest rate sensitive than in the past, it generally takes roughly a year before the full brunt of monetary tightening has time to flow through the entire economy. Therefore, the impact of last year's interest rate hikes is yet to be fully felt.

The equity market, as measured by the Standard & Poor's 500 Index, climbed in the first quarter, mainly driven by the sharp rise in a few large capitalization growth stocks. The type of market concentration we see today was also present in the late 1990's and the early 1970's. The path of stock prices in the coming months will be heavily influenced by the degree of the economic slowdown. Since 1957, the Standard & Poor's 500 Index has never bottomed before a recession began. However, in nine of the last ten recessions, the market low occurred prior to the end of the recession.

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THE ECONOMY

The next economic downturn has been anticipated to be a mere six months away for over a year now, and still a recession has yet to arrive. The government's pandemic stimulus left household and business finances in unusually strong shape. The Federal Reserve estimates that households had amassed $2.3 trillion in extra savings by the fall of 2021. Households in the lower half of the income distribution were still holding about $350 billion in excess savings as recently as last fall. This excess is quite a shift from a decade ago when only half of American households had enough cash on hand to pay for a surprise $400 emergency expense without resorting to borrowing, according to the Federal Reserve. Elevated household savings have underpinned strong consumption; however, estimates suggest that most of this excess savings will be depleted by the end of the year.

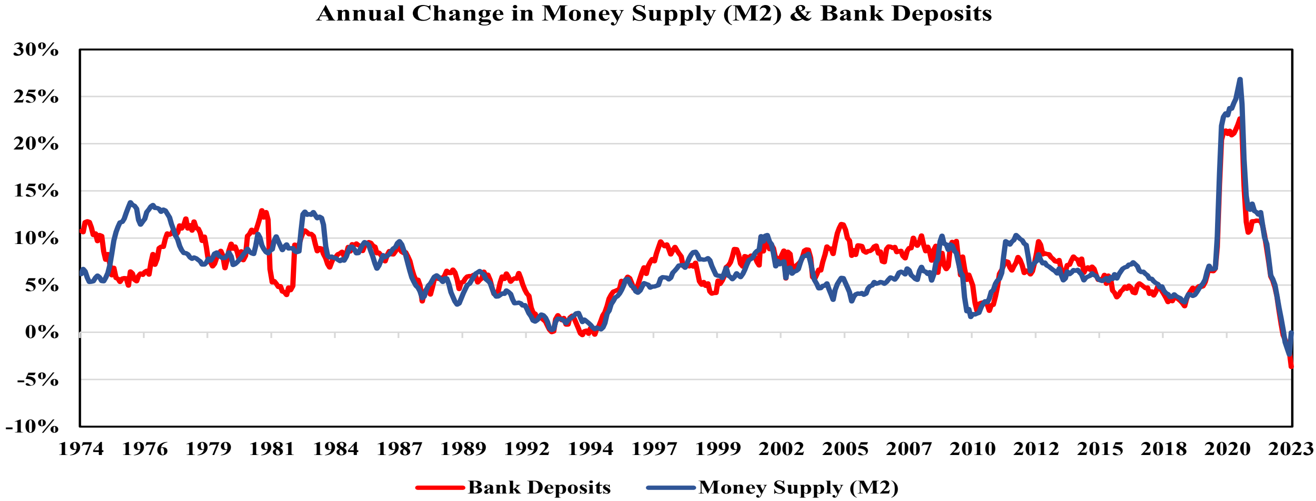
Another argument for a delayed recession, mentioned above, is that the U.S. economy is less interest rate sensitive than it has been in the past. The traditional framework for how the central bank slows the economy to bring down inflation is very familiar. The Federal Reserve tightens money to curb demand in sectors of the economy sensitive to interest rates such as housing (construction), and autos (durable goods manufacturing), causing them to contract. These sectors, to a significant degree, *are* the business cycle. They expand during good times and contract during hard times, while other sectors like health care are more consistent. However, broadly speaking, high interest rates add to the cost of doing business for most companies in myriad ways.

Interestingly, the sectors that typically shrink in response to monetary tightening have continued to add workers despite the rapid hike in interest rates. In fact, construction employment rose by 3.5% in 2022, increasing in all 12 months, while durable goods manufacturing employment increased by 4.3% and rose in 11 of the 12 months. Rather than losing momentum, both sectors continued to add jobs at a steady pace throughout the last year, and both sectors added jobs in January and February of this year. The strength of interest-sensitive sectors may reflect a backlog of demand for houses and autos from the supply-constrained period of 2021 (in other words a post-pandemic corollary). As long as supply lags demand, employers have no reason to lay off workers.

Resilience of labor in areas that are historically most affected by interest rate hikes, coupled with declining inflationary pressure, suggests to some investors that the Federal Reserve may be able to reduce inflation without triggering widespread job losses that typically occur during recessions. While this may be possible, the odds of this outcome remain low in our view.

Historically, a steady rise in initial jobless claims have been indicative of a weakening economy. At the beginning of an economic downturn, labor productivity tends to collapse. This occurs, despite a decline in output, because firms retain workers in the hope the economic lull will prove short lived. Layoffs begin in earnest only about two quarters after the start of a recession, as falling revenue forces employers to finally let workers go. Even in the modest recessions of 1990 and 2001, the monthly change in payrolls was at its most negative two quarters after the recession began. In the two deepest postwar recessions – 1997 and 2007 – payrolls began dropping steeply four quarters after the downturn began.

As the government and the Federal Reserve implemented policies to mitigate the pandemic's impact on the economy, the money supply increased significantly. The benchmark measure of how much cash and cash-like assets are circulating in the economy at any given time, what economists call "M2", was $15.5 trillion in February 2020 at the onset of the pandemic. The money supply rose 41% to a peak of $21.7 trillion in March of last year. At its peak, M2 was growing 26.9% year-over-year. The most recent February data, however, show the money supply contracted for the third consecutive month, falling 2.4% year-over-year to $21.1 trillion - it remains 36.3% above February 2020 levels! Below is a long-term chart of the annual change in M2 and bank deposits.



Source: Board of Governors of the Federal Reserve System

Changes in the money supply can reasonably be seen as changes in liquidity, which broadly influences everything from asset prices to inflationary pressures. In response to the pandemic, the most basic goal of fiscal and monetary stimulus was to flood the economy with liquidity. Through transfer payments, the government was even able to offset plummeting incomes to such an extent that disposable incomes

actually rose as the unemployment rate surged by its fastest pace in history. When liquidity begins to dry up, cracks initially appear in places where the surging money supply overwhelmed fundamentals. We witnessed such a crack in the banking industry in March. Bank runs of the type that occurred frequently beginning in 1929 were thought to be a fixture of the past. Layers of regulatory safeguards have been erected over time to stymie bank runs. However, the arms race among banks to embrace technology to ease financial transactional friction has left banks unwittingly vulnerable to massive deposit flight when fueled by fear. The Federal Reserve moved quickly to stand up a new program that would allow banks immediate access to cash by pledging securities held by the banks. This new paradigm has seemingly quieted the fear of bank runs. The longer-term implication will be the refinement and augmentation of bank regulations and perhaps some adjustments in accounting principles.

Bank deposits are likely to remain under pressure as depositors now have multiple options to park their cash outside the banking system in higher yielding vehicles, such as money market funds and Treasury bills. In general, banks need to attract deposits to expand loan balances. Credit creation is a crucial factor in the economy as it allows businesses to invest in new technologies, equipment, and infrastructure, which can improve productivity and competitiveness. This investment, in turn, can lead to increased output and job creation. Similarly, access to credit enables consumers to pull forward demand. The absence of available credit can stifle economic growth, particularly at a time when the economy is increasingly vulnerable due to tightening monetary conditions. Bank loans are also a crucial source of funding for small businesses, which employ about 46% of Americans who work in the private sector and have generated nearly two-thirds of jobs created since 1995, according to the U.S. Small Business Administration.

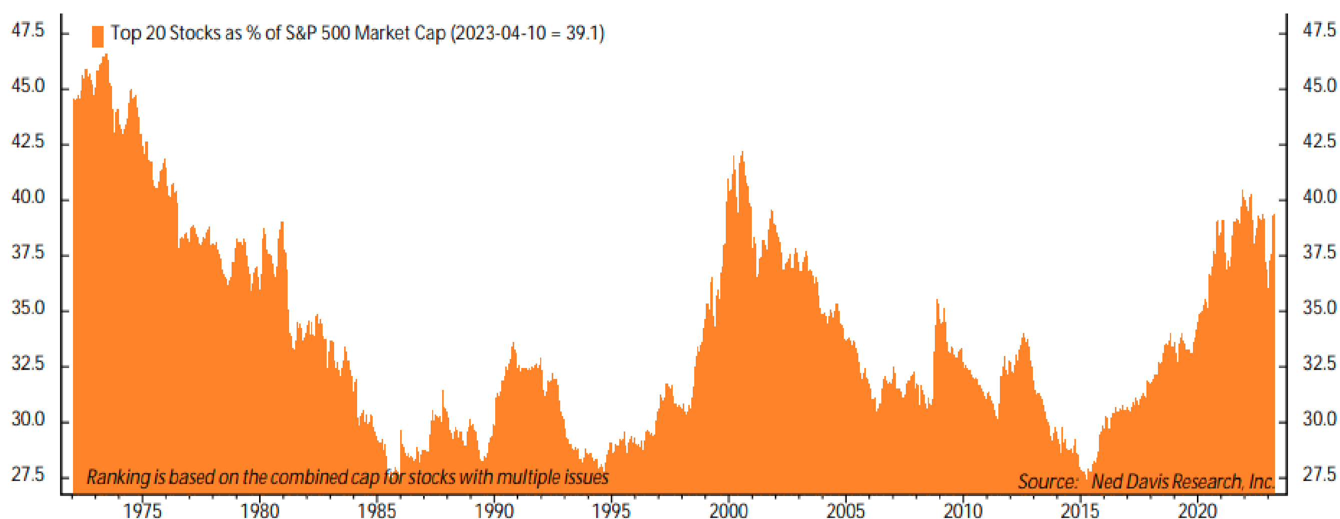
THE MARKET

The Standard & Poor's 500 Index climbed 7.5% in the first quarter, although the index was carried by the performance of a handful of companies. The Standard & Poor's 500 Index is a capitalization weighting index, meaning the largest companies in the index have the greatest impact on the performance of the index. For example, the behavior of Apple stock has the exact same impact on the index as the 194 smallest companies in the index combined. This impact is because Apple's $2.5 trillion valuation equals the sum of the market capitalization of the smallest 194 companies in the index. Only five companies (Apple, Microsoft, NVIDIA, Tesla, and Meta Platforms) accounted for 73% of the rise in the Standard & Poor's 500 Index during the first quarter. Although the capitalization weighted index rose 7.5% during

the first quarter, the equal weighted market capitalization Standard & Poor's 500 Index returned only 2.9%.

Moreover, the forty largest stocks in the Standard & Poor's 500 Index, or 8.0% of the index, represent 39.2% of the of the index's total market capitalization. As the chart below illustrates, the current level of index concentration is reminiscent of the peak in the Tech Bubble of 2000 and harkens back to the "Nifty Fifty" stocks of the 1970's. The five largest companies alone represent 18.3% of the total market capitalization of the index. Such a high concentration in the top five holdings potentially leaves investors vulnerable if valuations of these companies fall sharply as occurred in the late 1990's and the early 1970's. History teaches us that companies with once seemingly unassailable market positions can and do fade as their business models are disrupted, fall victim to competitive forces, or are challenged to grow revenue and earnings from very elevated levels.

Standard & Poor's 500 Index Concentration

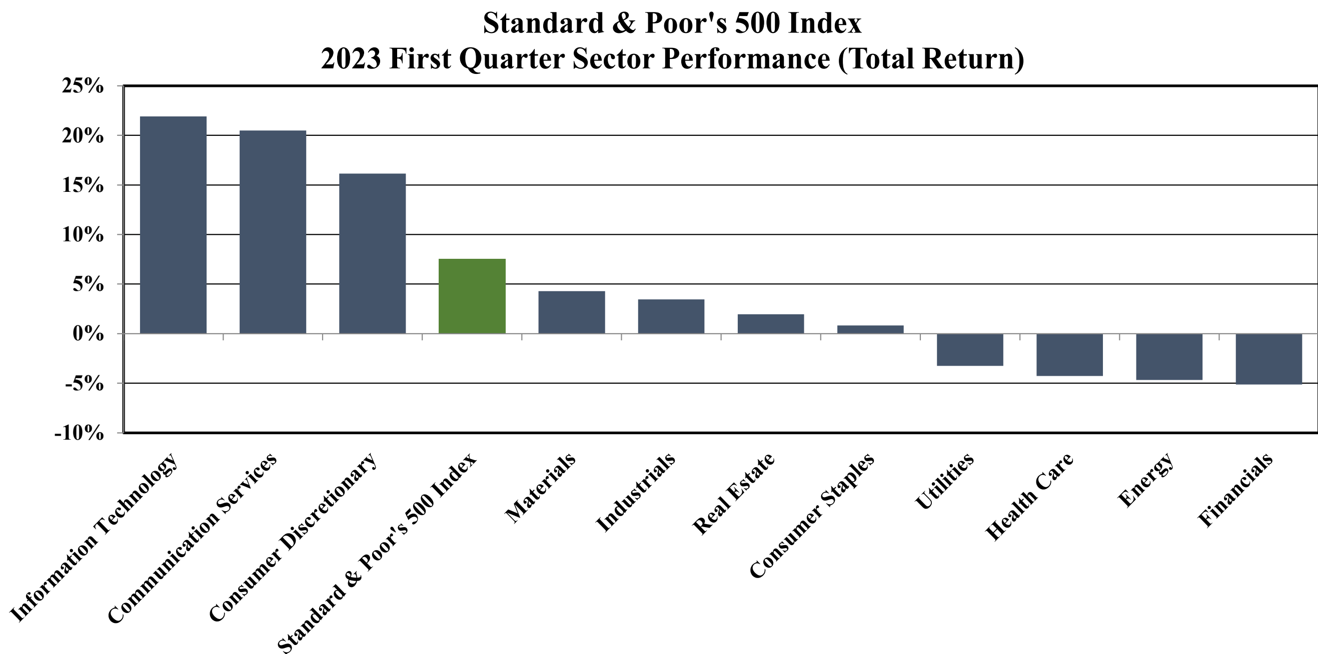


Source: Ned Davis Research, Inc.

In 1970, the top five holdings in the Standard & Poor's 500 Index were IBM, AT&T, General Motors, Standard Oil of New Jersey, and Eastman Kodak. By 2000, GE, ExxonMobil (the successor to Standard Oil of New Jersey, including a merger with Mobil), Pfizer, Citigroup, and Cisco occupied the top five positions within the index. Today, ExxonMobil is the only one of the ten aforementioned companies that retains a spot among the top ten largest companies.

The behavior of capital markets in the first quarter was largely the reversal of the prior year's performance. After the Energy sector posted its best relative performance versus the Standard & Poor's 500 Index on

record last year, the Energy sector was the second worst performing sector in the first quarter. Only three of the eleven sectors of the equity market finished ahead of the Standard & Poor's 500 Index during the first quarter as shown in the chart below.



Source: Thomson Reuters Eikon

CONCLUSION

It has been our forecast that reducing inflation from its peak of 9.1% to a range of 4.0% – 5.0% would not be the crucial hurdle. Rather, narrowing the gap from say 4.0% – 5.0% to 2.0% would be the greatest challenge. The central question is whether the economy needs unemployment to rise in order to restore price stability that is satisfactory to the central bank. The economy is currently in the most vulnerable phase of the business cycle. If the Federal Reserve believes it is necessary to coax unemployment higher to bring about lower wage pressures, then the economy will likely enter a recession. Such an economic downturn remains our base case.

A variation on the recession theme, would be an economic "soft" landing in which the Federal Reserve is successful in pulling down inflation to its target without causing a recession. This would likely necessitate housing bottoming before unemployment moves materially higher. Further interest rate hikes make this outcome less likely.

*FINANCIAL MARKET TOTAL RETURN**

	First Quarter 2023	Six Months Ending 03/31/23	One Year Ending 03/31/23	Annualized Return Two Years Ending 03/31/23	Annualized Return Three Years Ending 03/31/23	Annualized Return Five Years Ending 03/31/23
Standard & Poor's 500 Index	7.50%	15.62%	(7.73%)	3.30%	18.60%	11.19%
Russell 2000 Index	2.74%	9.14%	(11.61%)	(8.74%)	17.51%	4.71%
Value Line Composite Index	4.68%	14.77%	(10.39%)	(4.63%)	18.71%	2.47%
Dow Jones Industrial Average	0.93%	17.09%	(1.98%)	2.47%	17.31%	9.01%
NASDAQ (OTC) Composite	17.05%	16.14%	(13.25%)	(3.17%)	17.60%	12.62%
Bloomberg Gov't/Credit Intermediate Bond Index	2.33%	3.91%	(1.66%)	(2.89%)	(1.28%)	1.40%

* *Total Return Includes Income*

Michael C. Yeager, CFA
April 10, 2023

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