LUTHER KING CAPITAL MANAGEMENT

SECOND QUARTER 2023 REVIEW

The key domestic economic themes remain largely unchanged. Households have exceptionally healthy balance sheets. The self-sustaining cycle of employment, income, and spending are supporting economic growth. A recent spate of stronger economic readings has allayed recession fears gauging from the recent uptick in investor sentiment and positive equity market returns. The Federal Reserve has seemingly delivered an appropriate amount of monetary tightening via higher interest rates to trigger disinflation. However, there appears to be some debate among members of the Federal Open Market Committee as to the economic impact of past interest rates hikes. This debate raises the important question of whether the economy is about to feel the true bite of monetary tightness or more tightening will be required to reduce inflation to the Federal Reserve's target of 2.0%.

The severe economic downturn which would have accompanied the pandemic lockdown was short circuited by massive policy stimulus. This action fueled a boom in crypto currencies, equity markets, real estate, and ultimately inflation. The boom then had to be countered by the current restrictive monetary policy. The Federal Reserve has tightened policy at the fastest pace in four decades and the money supply is contracting for the first time since the 1940's. Reflexively, the financial dominos have fallen in the same order in which they rose with the demise of crypto currencies, compression of equity values, and softer home prices last year. The final step in this sequence should be the retreat of high inflation. The battle against inflation has made significant progress, although official victory may yet be a year away because of the way in which shelter inflation is measured. This elevates the risk of a "policy mistake" by the central bank to the extent it believes there is much more work to be done to fight inflation.

Ironically, the economy may be its most vulnerable at the precise moment investors believe the Federal Reserve has engineered a "soft landing," defeating inflation while avoiding a recession. As aggregate demand declines, contributing to lower inflation, the risk of an overshoot rises. Thus, falling demand

could eventually lead to rising unemployment. Recessions are notoriously difficult to forecast. A key reason recessions are challenging to predict is that significant economic imbalances elicit non-linear behavior. It is like the observation of how a business goes bankrupt: very slowly and then all at once. Unemployment behaves similarly in an economic downturn. It historically rises very slowly, then very suddenly.

ECONOMY

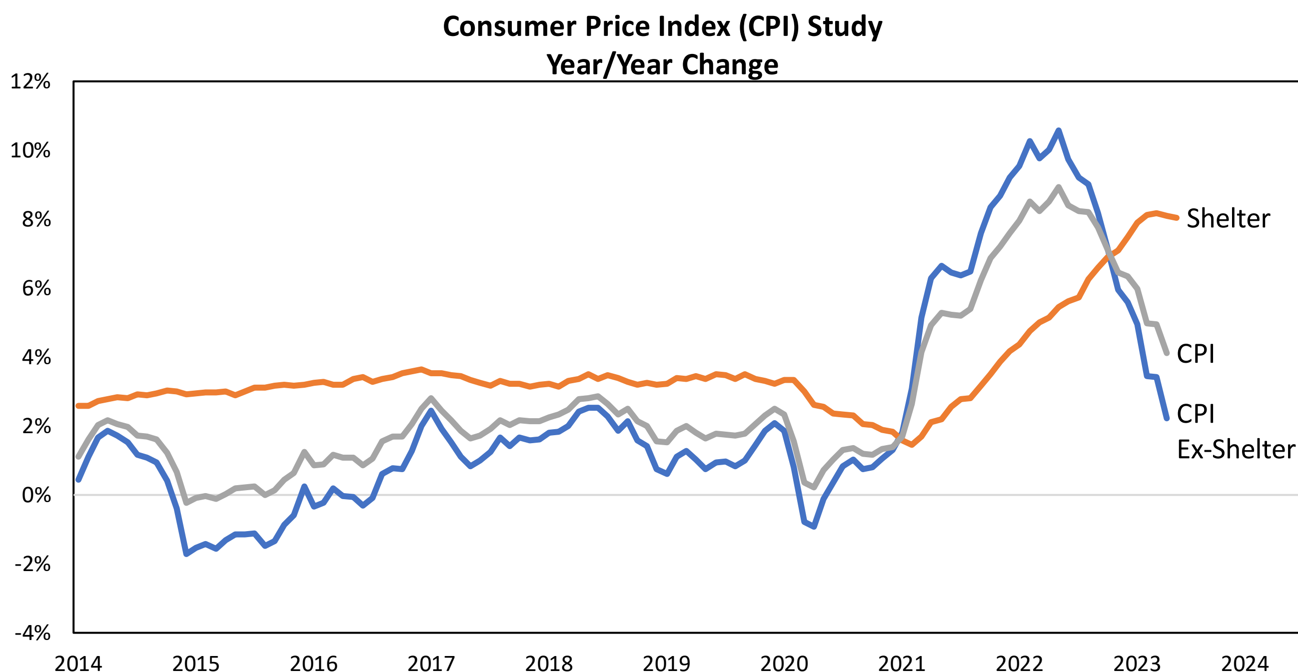
The U.S. economy has been very resilient to interest rate hikes. Over the span of fourteen months beginning in March of last year, the Federal Reserve raised its benchmark interest rate by 5.0%. This increase is the fastest pace of monetary tightening in four decades. Market rates of interest have climbed higher in response. The "prime" borrowing rate at banks is now 8.25%, up from 3.25% last March. Americans are currently paying 20.1% interest on their credit card balances compared with 14.6% a year ago. The interest rate on new 30-Year fixed rate mortgages has more than doubled to over 7.0% from the low that sparked a re-financing boom in 2020-2021.

As we have written before, monetary policy is generally accepted to act with a "long and variable lag." Federal Reserve Chair Jerome Powell emphasized this important point in his November press conference. One reason for the lag is that many transactions have prices (which affect inflation) and quantities (which affect employment and output) agreed upon well in advance. A key tenet to the recession case is that the economy should just now be feeling the constrictive effect of higher interest rates, fifteen months removed from the first interest rate hike.

Some policy makers have raised the question whether the economy is perhaps less interest rate sensitive than it has been in the past. Lorie Logan, Dallas Federal Reserve Bank President, recently remarked, "Some people say a lot of further cooling is in store from lagged consequences of the rate increases the FOMC has already made over the past year and a half. I'm skeptical about the potential for large additional effect from this channel." Her conclusion was that "The continuing outlook for above-target inflation and a stronger-than-expected labor market calls for more-restrictive monetary policy." In our view, the greatest economic risk is persistently elevated wage growth which brings further monetary tightening.

The Federal Reserve tends to break inflation into three components: goods, services (excluding shelter), and shelter. This decomposition of inflation leads to three very different narratives. Goods inflation (excluding food and energy) has evaporated as the pandemic induced consumption binge has faded and

supply chains have been repaired, with prices rising only 0.45% year-over-year in May. Services (excluding shelter) fell sharply to 4.17% in April from 5.18% in June 2022. The most significant driver of services (excluding shelter) is wage growth which remains strong at 4.4%. However, a leading indicator of wage growth, the number of workers that voluntarily "quit" their job has receded which suggests wage growth should continue to decline. Finally, shelter inflation remains a very high 8.03%. The measurement method for computing changes in the price of shelter ensure that the shelter component moves in a smooth, long-dated fashion. Real-time measures of apartment rents are declining rapidly and will slowly pull the shelter component lower. The following chart illustrates the slow-moving shelter component of CPI and importantly shows that the CPI excluding shelter is only 2.23%, which is close to the Federal Reserve's target of 2.0%.



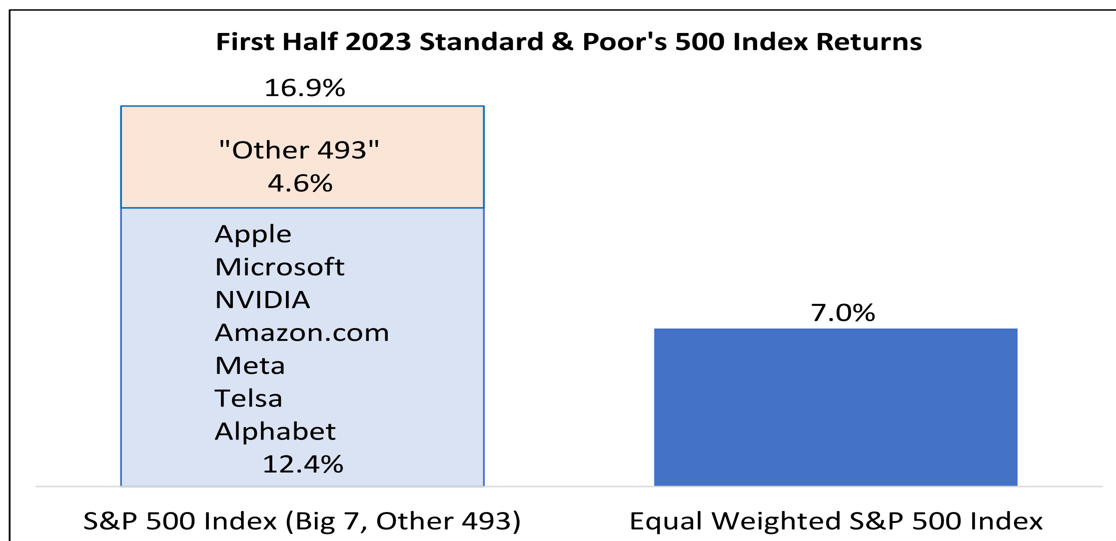
Source: Bureau of Labor Statistics, LKCM

The central bank is going to be reluctant to declare victory too early in its battle with inflation. However, following ten consecutive interest rate hikes the Federal Reserve chose to leave its benchmark interest rate unchanged at the recent June meeting. The central bank is likely heartened by the data illustrated above. The greatest concern for the FOMC is likely the trajectory of wages. If inflation were to stall around the current 4.1% level, it would likely be the result of the very tight labor market continuing to place upward pressure on worker pay. As a result, employment data is being viewed with heightened interest by investors. One strong employment reading in early July sent the yield on the 10-Year Treasury back above 4.0% as bond investors anticipated a resumption of rate hikes at the July FOMC meeting.

MARKETS

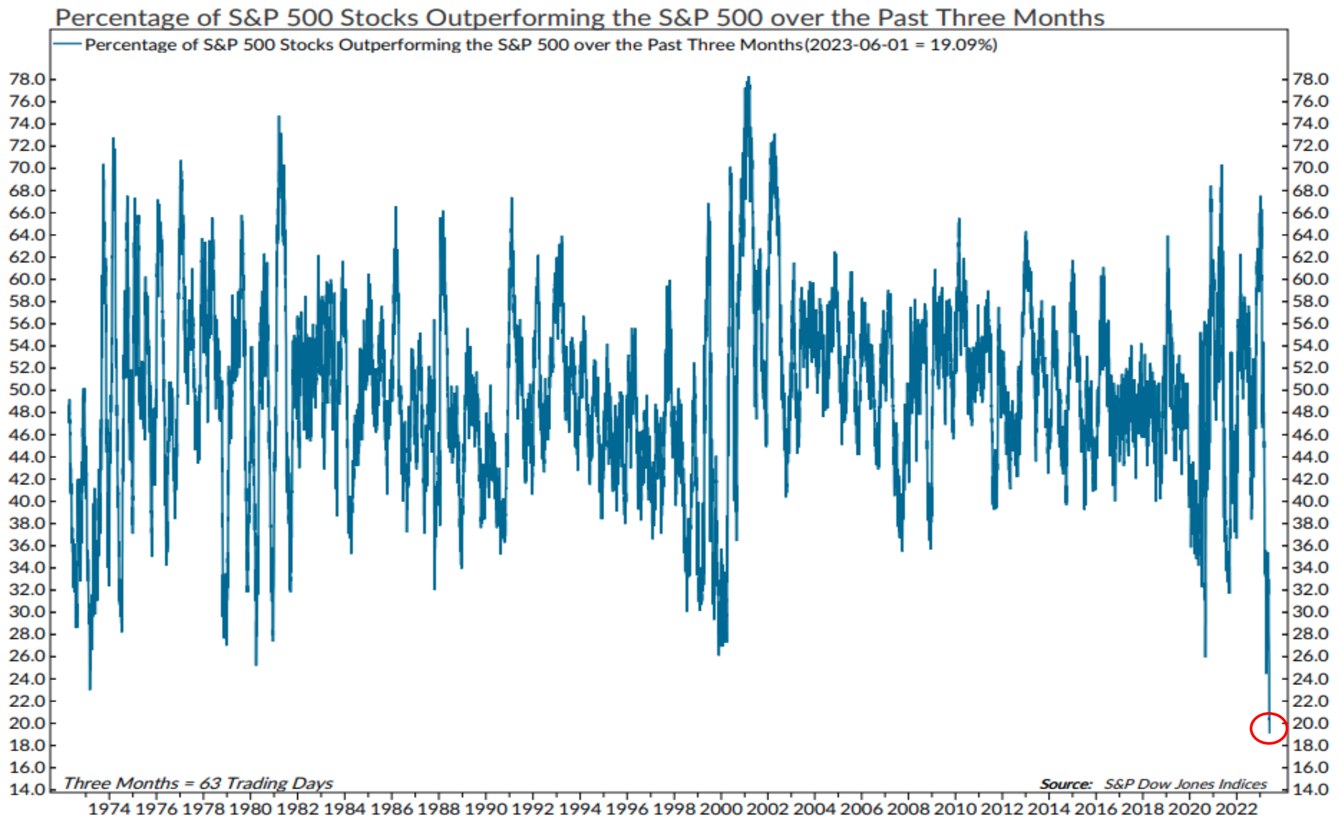
At the close of the second quarter, it would have cost you just over $3 trillion to purchase all the outstanding shares of Apple – a new high-water mark for a single publicly traded company. This value of Apple stock surpassed the combined value of three of the Standard & Poor's 500 Index eleven sectors (Materials, Real Estate, and Utilities). For the same $3 trillion investment, you could purchase the 204 smallest companies in the Standard & Poor's 500 Index! Apple is a phenomenal company by many measures and warrants a large market capitalization. Of the 7.33 billion people on the planet, 19% of them own an iPhone. In January of this year, Apple took the top spot for the largest smartphone market share globally at 27.7%, edging out Samsung, which the market now values at less than one-sixth of Apple.

Apple alone represents 7.4% of the Standard & Poor's 500 Index, while the ten largest companies in the index constitute 34.7% of the benchmark (Apple, Microsoft, Alphabet, Amazon.com, NVDIA, Tesla, Berkshire Hathaway, Meta, Visa, and UnitedHealth). The Standard & Poor's 500 Index is a "capitalization weighted" index which emphasizes the movements of its largest members. As Apple and its other large technology-related cousins have grown in value, they have exerted outsized influence on the Standard & Poor's 500 Index. As the following chart illustrates, seven companies accounted for nearly three quarters of the return in the Standard & Poor's 500 Index during the first half of the year. The remaining 493 companies produced roughly one quarter of the return. The "average" stock in the index returned 7.0% during the first half of the year, although all the gain occurred during June as the equal weighted Standard & Poor's 500 Index was negative for the year at the end of May.



Source: Thomson Reuters, Bloomberg, LKCM

In fact, the lift in the top-heavy Standard & Poor's 500 Index was so great during May, that by June 1st only 19% of the stocks that comprise the benchmark were ahead of the index over a three-month period. That marked the lowest level on record dating back to 1973 as shown in the chart below.



Source: Ned Davis Research

The handful of technology-related companies that have led the market higher this year have done so for a variety of reasons. First, growth stocks tend to outperform value stocks when the economy is slowing. This rotation is particularly acute given the dramatic outperformance of value stocks last year. Second, earnings growth for many of these leading companies is higher than the broader market. Finally, and most importantly, Generative Artificial Intelligence (GAI) has recently captured the imagination of investors as measured by the number of periodicals with AI themed covers, including The Economist and Bloomberg Business Week. Much of the excitement is attributable to the introduction of ChatGPT last November by privately held OpenAI, which counts Microsoft as an investor. The launch of ChatGPT introduced "Generative Pre-Trained Transformer" (GPT) technology to a mass audience. The free ChatGPT application reached 100 million unique users in less than two months, seven months faster than it took TikTok to reach the same milestone.

The impact of GAI is going to have an immense impact on many industries and significantly reshape portions of the economy. We are working diligently to evaluate and understand how GAI will impact the investment landscape. Some of our initial observations are that GAI is going to accelerate the trends of mass individuation. The way in which consumers interact with companies and consume content will increasingly be personally tailored. GAI will provide a step-function increase in productivity for select industries. The value of authentic experiences, such as travel and live sports, will likely rise. New businesses will emerge that do not exist today anchored around harnessing GAI. Finally, there will be downside, such as the proliferation of "deep fakes" or the inability to readily determine what is real and what is not in a variety of contexts.

CONCLUSION

Chicago Federal Reserve Bank President, Austan Goolsbee, said "We are in this weird foggy environment where is it hard to figure out where the road is," when asked about the recent FOMC decision to pause intertest rate hikes. Weird foggy environment, indeed. The economy continues to exhibit signs of moderating in the wake of the pandemic stimulus boom. Inflation is methodically retreating, and the odds of a soft landing appear to be rising, but this call may be premature. The outstanding policy question is how much more, if any, monetary tightening remains in our future. To answer this question, the central bank will likely need to reasonably estimate the impact of actions already taken to tighten monetary policy. Success for the Federal Reserve would be that the current economic expansion continues with inflation returning to their target of 2.0%, and this period could join 1964, 1984, and 1993 as examples of the few times during which the central bank tightened monetary policy without sparking a recession.

*FINANCIAL MARKET TOTAL RETURN**

	Second Quarter 2023	Six Months Ending 06/30/23	One Year Ending 06/30/23	Annualized Return Two Years Ending 06/30/23	Annualized Return Three Years Ending 06/30/23	Annualized Return Five Years Ending 06/30/23
Standard & Poor's 500 Index	8.74%	16.89%	19.59%	3.39%	14.60%	12.31%
Russell 2000 Index	5.21%	8.09%	12.31%	(8.34%)	10.82%	4.21%
Value Line Composite Index	2.98%	7.80%	11.31%	(5.97%)	11.14%	2.13%
Dow Jones Industrial Average	3.97%	4.94%	14.23%	1.92%	12.30%	9.59%
NASDAQ (OTC) Composite	13.05%	32.32%	26.17%	(1.69%)	11.98%	13.96%
Bloomberg Gov't/Credit Intermediate Bond Index	(0.81%)	1.50%	(0.10%)	(3.75%)	(2.45%)	1.23%

* *Total Return Includes Income*

Michael C. Yeager, CFA
July 7, 2023

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