LUTHER KING CAPITAL MANAGEMENT

THIRD QUARTER 2023 REVIEW

The economy may be most vulnerable at the precise moment investors believe the Federal Reserve has engineered a "soft landing," by defeating inflation while avoiding a recession. When the economy operates with little or no slack, as it does today, any increase in demand could potentially boost inflation, while anything that reduces demand could lead to a rise in the unemployment rate. Once spurred, the unemployment rate tends to rise rapidly. The consumer is potentially facing several headwinds that may weigh on consumption in the coming months including a historic autoworkers strike, a potential government shutdown, rising energy prices, and the resumption of student loan repayments. Whether these events will cause an economic downturn is unknown, but they will likely result in slower economic growth.

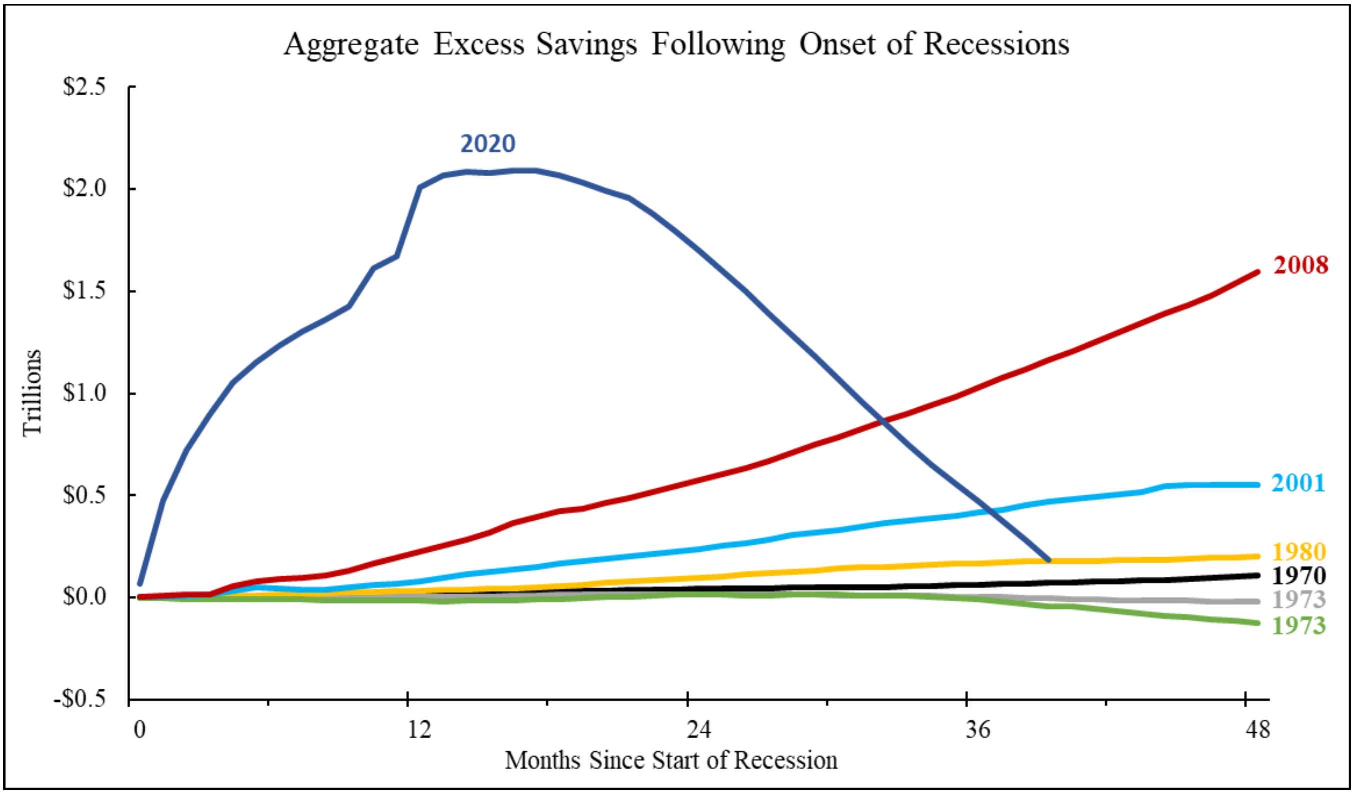
Restrictive monetary policy and expansive fiscal policy continue to be at odds with one another. The purpose of fiscal policy is to be an automatic stabilizer for the economy by expanding government outlays at times consumer and business spending contract. Despite the economy growing above its long-term potential this year, federal deficit spending was roughly 7% of Gross Domestic Product (GDP) in the fiscal year ending in September – almost twice as large as the previous year. Procyclical fiscal policy and a cash rich consumer have overwhelmed natural parts of the business cycle.

Equity returns, as measured by the Standard & Poor's 500 Index, fell 3.3% during the third quarter. Contributing to lower prices was a sharp move higher in long-term bond yields, which rose in both July and August and accelerated in September. Intriguing is the shift in behavior of bond yields relative to economic data that began in September. On balance, some economic data softened late in the quarter, which would suggest lower bond yields on the premise that the Federal Reserve is approaching the end of further interest rate increases. Concerns about mounting federal debt, a recent downgrade of the nation's credit rating, and Congress' struggle to govern could provide possible explanations for the recent surge in bond yields.

ECONOMY

Economic growth has been solid through the first three quarters of the year for the U.S. economy. The Federal Reserve has been diligent in its pursuit to pull inflation lower towards its 2.0% target, without unsettling the labor market and triggering a recession. In August the central bank's preferred inflation gauge, U.S. Personal Consumption Expenditures, climbed 3.5% from a year earlier – far below its 7.1% peak. Despite the Federal Reserve raising interest rates by 5.25% over the past year and a half, the unemployment rate has risen only 0.2% to 3.8% - remaining near a half century low. The marked deceleration in headline inflation, tight labor markets, above-trend growth in real GDP, and below-average levels of financial stress have led many investors to conclude that the Federal Reserve will deliver on its goal of a soft landing for the economy.

Fiscal stimulus has played an important role in supporting both consumption and private investment. So much fiscal stimulus has been injected into the economy that it continues to reverberate in ways that make it challenging for the central bank to calibrate monetary policy. This challenge can clearly be seen in the estimate of aggregated excess consumer savings figures, as calculated by the San Francisco Federal Reserve. The pandemic turned home-bound Americans into super-savers. More than 476 million direct transfers totaling $814 billion in financial relief went to households to mitigate the economic shock of the pandemic. This action dramatically shifted the saving paradigm around recessions. Traditionally, the percent of disposable income that consumers hold back in savings rises during a recession, as growing uncertainty contributes to cautionary spending. The turbocharged savings that occurred following the brief 2020 recession has been finding its way back into the economy and is evident in strong consumption data over the past several years. This excess savings, however, is estimated to be exhausted before yearend. We can already see the corollary to falling excess savings in the sharp rise in credit card balances.



Source: Bureau of Economic Analysis, Federal Reserve Bank of San Francisco, LKCM

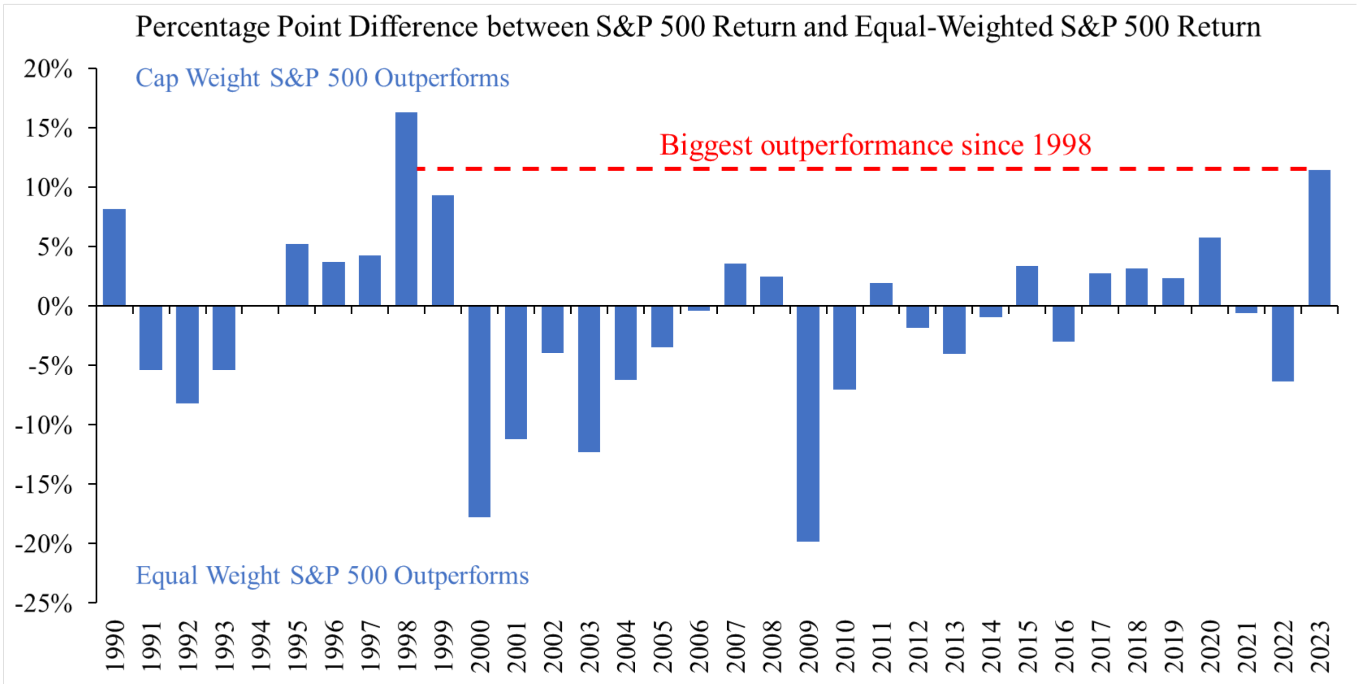
Nonresidential construction activity has been another key driver of economic momentum this year. Three new laws have boosted direct spending or indirectly contributed through government subsidies to private companies. The Inflation Reduction Act of 2022 (up to $1.5 trillion of capital into clean energy including advanced manufacturing production credits), 2021 Chips and Science Act ($52.7 billion for semiconductor R&D, manufacturing and investment tax credits), and the 2021 Infrastructure Investment and Jobs Act ($110 billion of incentives to improve energy efficiency in homes, buildings, and manufacturing facilities) have all been meaningful. Following the disruption to supply chains caused by the pandemic, domestic companies are keen to bring production closer to their home market. Geopolitical tensions between China and the West further drive this shift. Additional factors include automation to battle labor shortages, and the need for greater energy efficiency. As a result, spending on construction projects for manufacturing plants began to break out of its long doldrums in January of 2021 when about $6 billion was invested in building factories, about the same amount as in January 2015. In July of this year, spending on factories reached $17 billion, an increase of 186%.

In part due to the fiscal stimulus, the economy's actual output relative to its maximum potential output is very narrow. The economy is making very efficient use of its existing resources to generate goods and services. A primary input, labor, remains chronically undersupplied. For almost two decades, the labor market had more unemployed workers than job openings. Today, there are 1.5 jobs available for every unemployed worker and the demographic outlook is not encouraging. The median age in the U.S. increased by 3.4 years between 2000 and 2022, and it is expected to keep rising. Consequently, the share of working-age people (ages 15-64) in the U.S. population peaked at 67.3% in 2007 and currently stands at 64.9%. At the same time, the share of people dependent on the working-age population has increased since 2010 – a trend that is likely to continue.

While there may be continued debate among policymakers about the magnitude of the knock-on effects of monetary policy that has been dramatically tightening over the past year and a half, what appears clear in our view is that monetary policy has finally and decidedly reached a restrictive level. This shift is evident in several ways, including positive and rising *real* rates of interest (after accounting for inflation) and tightening financial conditions. As a result, the odds of increased financial stress or a more rapid reversal of economic growth have risen in our view.

MARKETS

The "new bull market" that emerged nearly a year ago has several characteristics that make it quite unique. First, this marks the only time in roughly 100 years that bank stocks are lower one year following the beginning of a new bull market. Second, small cap companies typically lead in the first year of a fresh bull market by posting some of the sharpest and largest gains. While the Standard & Poor's 500 Index stands 21.8% above its market bottom of last October, including dividends, the small capitalization Russell 2000 Index has risen only 7.4%. Finally, the capitalization constructed Standard & Poor's 500 Index continues to be driven by a few big-name technology-related companies. These seven large companies (Alphabet, Amazon, Apple, Meta, Microsoft, Telsa, and NVDIA) comprise nearly a quarter of the index and accounted for 84.2% of the Standard & Poor's 500 Index's return through the first three quarters of the year. As a result, the capitalization weighted Standard & Poor's 500 Index has outpaced the Equal Weighted Standard & Poor's 500 Index by 11.3% through the first three quarters of the year, the widest margin since 1998 as shown on the following page.



Source: Bloomberg, LKCM

The Federal Reserve has been raising its short-term benchmark rate for a year and a half, but only in the last few months have long-term rates shifted decisively higher. This action has refocused attention on the inverted yield curve and its history of preceding recessions. U.S. Treasury yields measure the interest rates of bonds over a range of time, which can range from a single month to thirty years. Under normal circumstances, longer maturity bonds yield more than short-dated bonds, represented by an upward sloping yield curve. This structure logically reflects the idea that investors should earn a return premium for the greater uncertainly inherent in lending money over a longer period. The yield curve inverts when long-term interest rates drop below short-term interest rates, indicating that investors are moving money from short-term bonds to long-term bonds. This suggests that investors overall are becoming more pessimistic about future economic prospects.

As the current Federal Reserve tightening cycle appears to be in the final stages, many investors expected the U.S. dollar to falter as the stampede of cash that raced in to seize rising rates would slow dramatically. Instead, a widening rift in the global economy, as growth in China and Europe falls below that of the U.S., has further increased the value of the dollar against other major currencies over the last two months. Countries, including China and Japan, are intervening to protect their currencies. Domestically, companies with significant earnings generated outside the U.S. must expect lower earnings when translated back into U.S. dollars. These actions are reminiscent of 2022, when the U.S. dollar delivered economic shocks by pushing up the price of commodities in global markets and increasing the cost of servicing U.S. dollar denominated debt.

CONCLUSION

A year ago, Federal Reserve Chairman, Jerome Powell, delivered a stark warning: To fight persistently high inflation, the Federal Reserve would continue to sharply raise interest rates, bringing "some pain" in the form of job losses and weaker economic growth. The central bank has clearly followed through on its resolve to sharply raise interest rates to curb inflation. The fallout includes dramatically higher loan rates for consumers looking to make major purchases such as homes and autos, yet the economic pain from job losses and weaker economic growth has yet to emerge. In fact, economic growth likely accelerated in the third quarter.

The economy has yet to fully absorb the substantial monetary tightening that has occurred over the past year and a half in our view. Mitigating circumstances this business cycle, such as ballooning consumer savings and fiscally encouraged business investment, have diluted the impact of restrictive monetary policy. However, late in the third quarter real long-term interest rates began to move decidedly higher which tighten financial conditions as we enter the fourth quarter. Whether a slowdown in economy activity results in a recession is likely to be unclear until early next year.

*FINANCIAL MARKET TOTAL RETURN**

	Third Quarter 2023	Nine Months Ending 09/30/23	One Year Ending 09/30/23	Annualized Return Two Years Ending 09/30/23	Annualized Return Three Years Ending 09/30/23	Annualized Return Five Years Ending 09/30/23
Standard & Poor's 500 Index	(3.27%)	13.07%	21.62%	1.39%	10.15%	9.92%
Russell 2000 Index	(5.13%)	2.54%	8.93%	(8.71%)	7.16%	2.40%
Value Line Composite Index	(5.38%)	2.00%	11.84%	(6.75%)	7.71%	0.44%
Dow Jones Industrial Average	(2.10%)	2.73%	19.18%	1.59%	8.62%	7.14%
NASDAQ (OTC) Composite	(3.94%)	27.11%	26.13%	(3.54%)	6.65%	11.44%
Bloomberg Gov't/Credit Intermediate Bond Index	(0.83%)	0.65%	2.20%	(4.17%)	(2.93%)	1.02%

* *Total Return Includes Income*

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October 5, 2023

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