LUTHER KING CAPITAL MANAGEMENT

2023 REVIEW

Entering 2023, headline inflation was running at 6.5%, and the unemployment rate was at a half-century low of 3.5%. Ninety-eight percent of CEOs were preparing for a recession in the year ahead, according to the Conference Board's CEO Confidence Survey. This pessimism was well founded by the economic assumption that there is supposed to be a short-term tradeoff between inflation and unemployment. The cost of lowering inflation has historically been higher unemployment. When people lose their jobs – or worry about losing their jobs – they rein in spending, which leads to reduced demand and, ultimately, lower prices. This is how the economy operated the last time the Federal Reserve battled high inflation in the 1970s. Fifty years ago, the result was a deep recession, an extended period of muted economic growth, and higher prices aptly labeled stagflation.

The critical factor that helped the U.S. economy avoid a recession in 2023 was the resilience of consumers. Despite ongoing challenges, such as the war in Europe, significant bank failures in the spring, and the persistent pressure of higher interest rates and tighter financial conditions, economic growth continued to accelerate through the third quarter of 2023. According to the latest data, the economy grew at an annualized rate of 4.9% in the third quarter before inflation. The strength was driven by consumer spending, which grew at a seasonally adjusted annual rate of 3.6%, contributing 2.5% to real GDP growth. The recovery in consumption following the pandemic recession was notably strong, surpassing the performance after recent recessions. A resilient labor market, increasing incomes, the surplus of savings from pandemic-related government transfers, and low debt service ratios all played a role in sustaining this resilient spending trend.

The exceptionally robust labor market is a key driver of robust consumer spending. The pandemic recession witnessed an unprecedented loss of 22 million jobs, surpassing any previous economic downturn. However, the recovery was remarkably swift. In contrast to the prolonged jobless recoveries

of the 2001 and 2007 recessions, which took nearly four and six years to regain lost jobs, the pandemic recession saw a full recovery within just 2.5 years. Notably, an additional five million jobs have been created beyond pre-recession levels. The unemployment rate has consistently stayed below 4% for a record 21 months, marking the lengthiest sub-4% unemployment streak since the 1960s.

The buoyant labor market has contributed to an upswing in income post-pandemic. Real per capita incomes have ascended since 2022, reaching a year-over-year growth rate not witnessed since early 2015. Increased real income and stimulus payments during the pandemic bolstered consumer wallets. As of October 2023, total consumer bank deposits reached a peak of $17.4 trillion, corresponding to diminishing debt service ratios and elevated net worth. Debt service ratios, having stayed below 10% since 2012, were pushed to historical lows by government transfer payments during the pandemic.

Turning to the equity market, there are 2,385 stocks listed on the New York Stock Exchange and 3,611 listed on the Nasdaq, which traditionally has more technology-rated companies than the New York Stock Exchange. With 5,996 combined companies across the two primary listing exchanges, there are several methods of accessing stock market performance. The granddaddy of stock market indices is the Dow Jones Industrial Average, first published in 1896 by two financial reporters, Charles Dow and Edward Jones (published as the Dow Jones Average beginning in 1885). The index methodology for the Dow Jones Industrial Average, consisting of thirty stocks, quite a narrow list, is to weigh the stocks according to their stock price. Thus, UnitedHealth Group, with a stock price of $526.47 per share at yearend, had a weight of 9.2% within the thirty-stock composite. Conversely, Walgreens Boots Alliance had a stock price of $26.11 per share at yearend, accounting for just 0.5% of the Dow Jones Industrial Average.

The Standard & Poor's 500 Index is a broader composite consisting of 500 stocks weighted by the market capitalization of each company. Market capitalization is the capital it would take to purchase every company share. For example, in the case of Apple, it would have taken $3.0 trillion to purchase all the company stock at yearend. There is an intuitive case to be made for weighting the largest – one could, therefore, argue the most important – companies in the index.

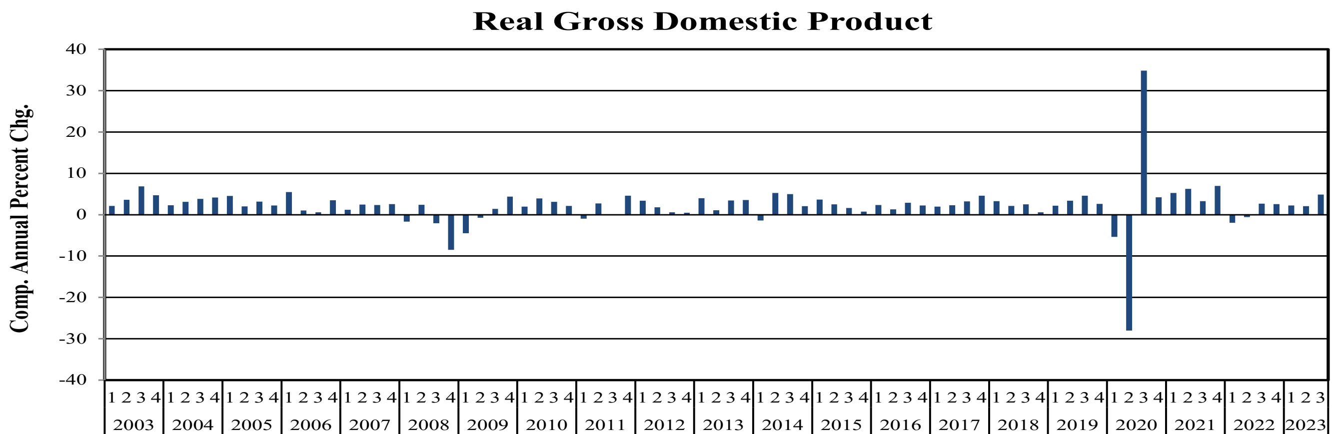
An alternative to the capitalization approach is to equal weight the 500 stocks in the Standard & Poor's 500 Index. If not for a small handful of the largest companies in the capitalization-weighted index performing meaningfully differently from the remaining ones, then you would naturally expect the capitalization-weighted and equal-weighted indexes to behave similarly. This alignment has historically been the case. For example, in the decade before the pandemic (2010 – 2019), the capitalization-weighted

index appreciated 256.3% compared to a 255.1% return for the equal-weighted index, including dividends for both indices.

In 2023, however, the shares of a small handful of technology-related companies (Apple, Microsoft, Alphabet – Google's parent company, Amazon, Nvidia, Meta, and Tesla) did exceptionally well, rising 107.0% on an equal-weighted basis. These seven stocks represented 28.1% of the capitalization-weighted index at the end of the year and accounted for 60.1% of the rise in the capitalization-weighted Standard & Poor's 500 Index. Conversely, the equal-weighted Standard & Poor's 500 Index returned 12.4% less than the capitalization-weighted version of the index, the widest margin in twenty-five years.

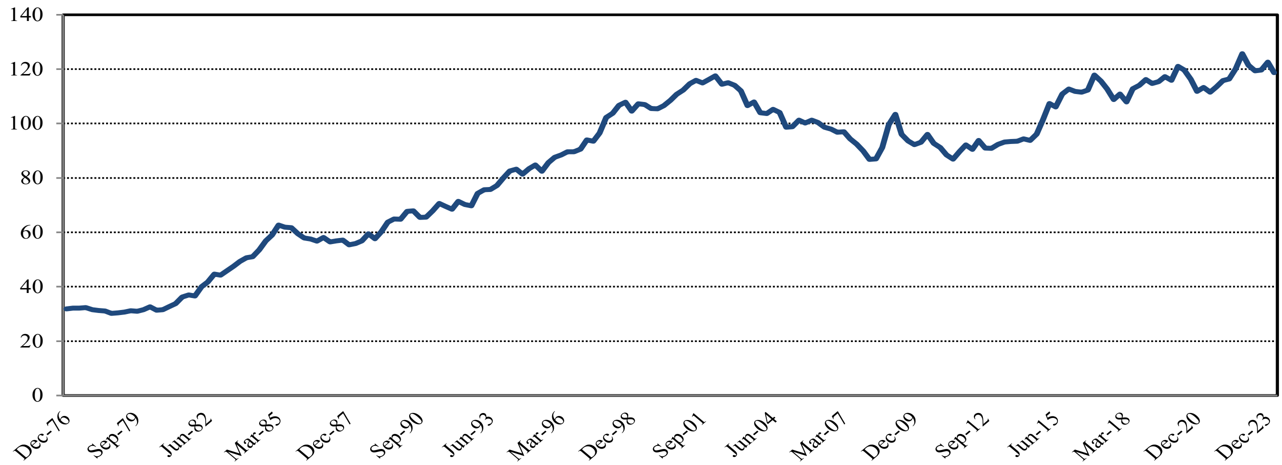
In 2023, these seven stocks that drove the Standard & Poor's 500 Index performance exhibited several shared characteristics. First, these stocks are all among the ten largest companies in the capitalization-weighted Standard & Poor's 500 Index. Second, each of these companies is perceived as benefiting from artificial intelligence. Finally, these stocks experienced a decline greater than the Standard & Poor's 500 Index during 2022.

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



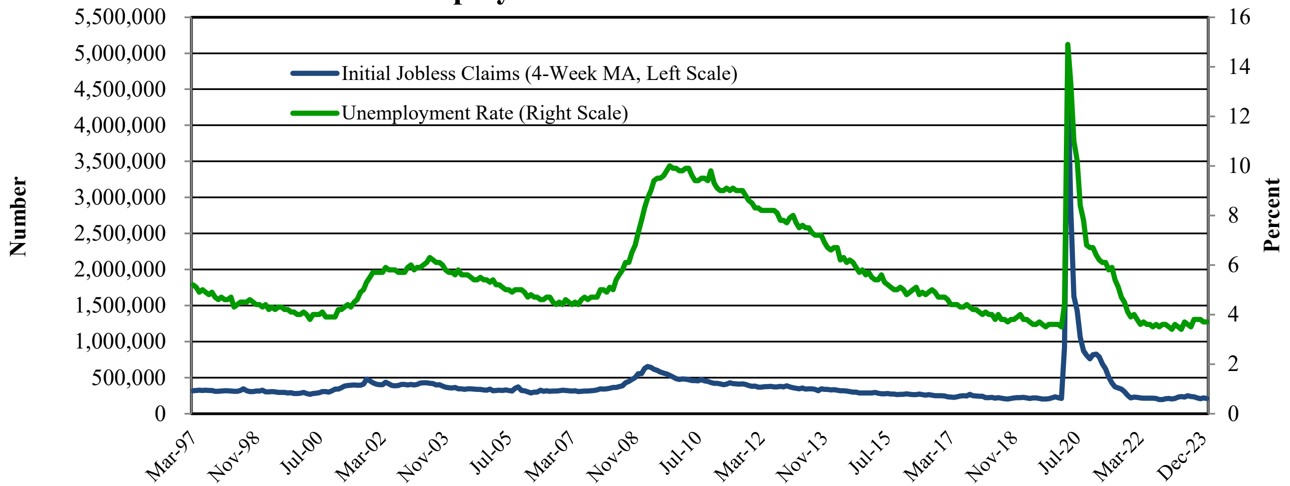
Source: U.S. Department of Commerce: Bureau of Economic Analysis

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



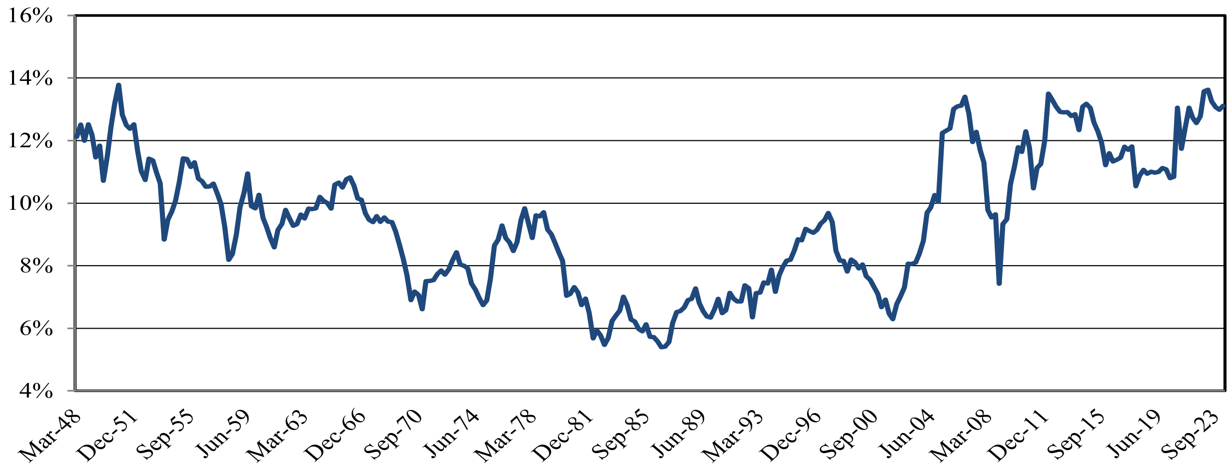
Source: Federal Reserve

Unemployment Rate & Initial Jobless Claims

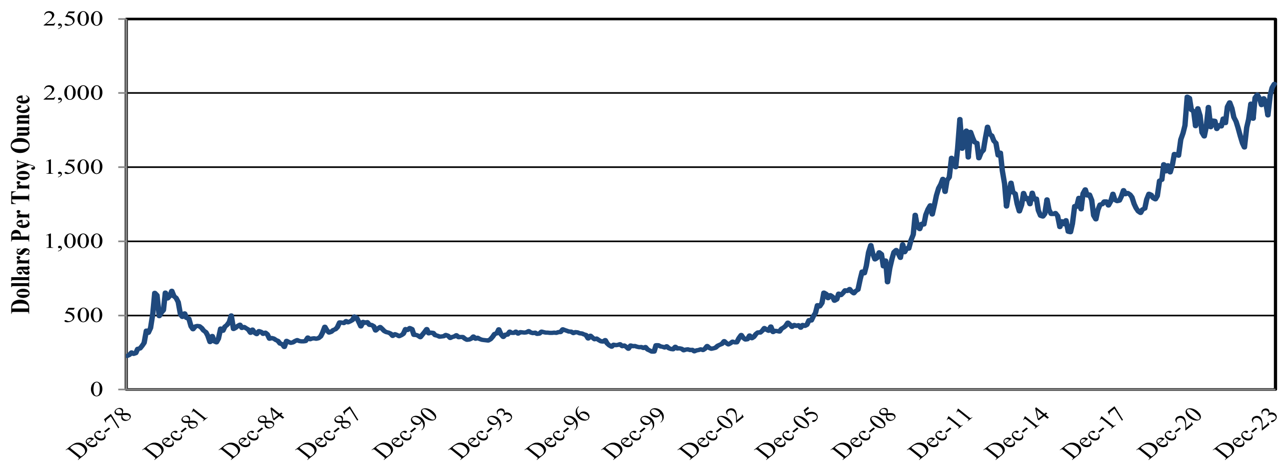


Source: U.S. Department of Labor: Employment and Training Administration/U.S. Department of Labor: Bureau of Labor Statistics

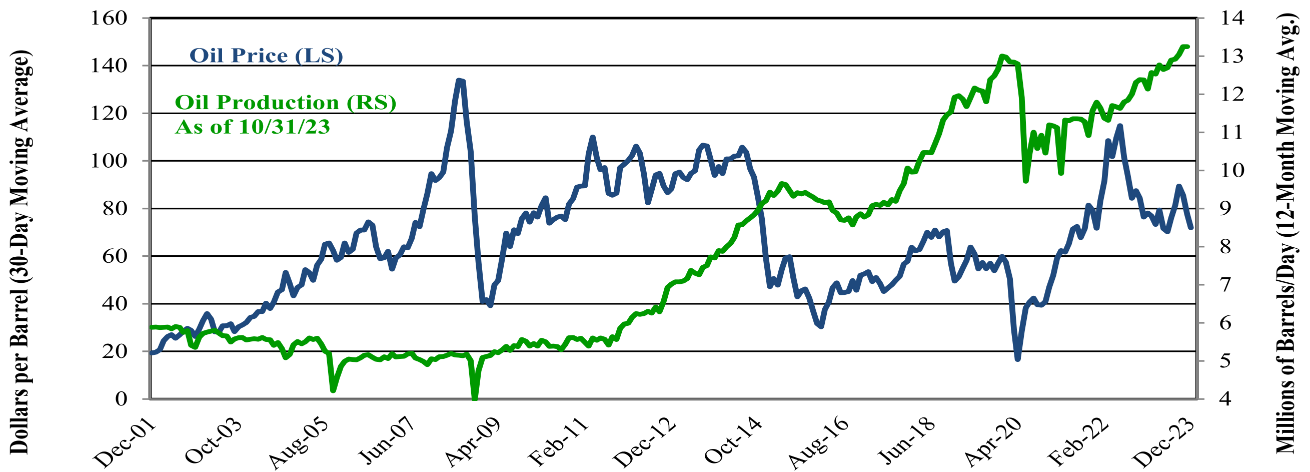
Corporate Profits as a Share of Gross Domestic Product



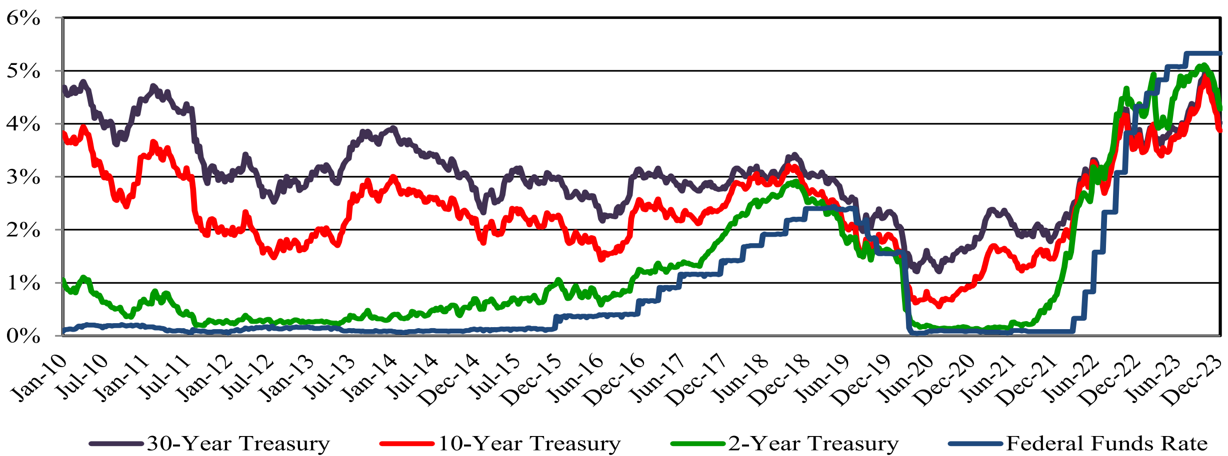
Source: U.S. Department of Commerce: Bureau of Economic Analysis



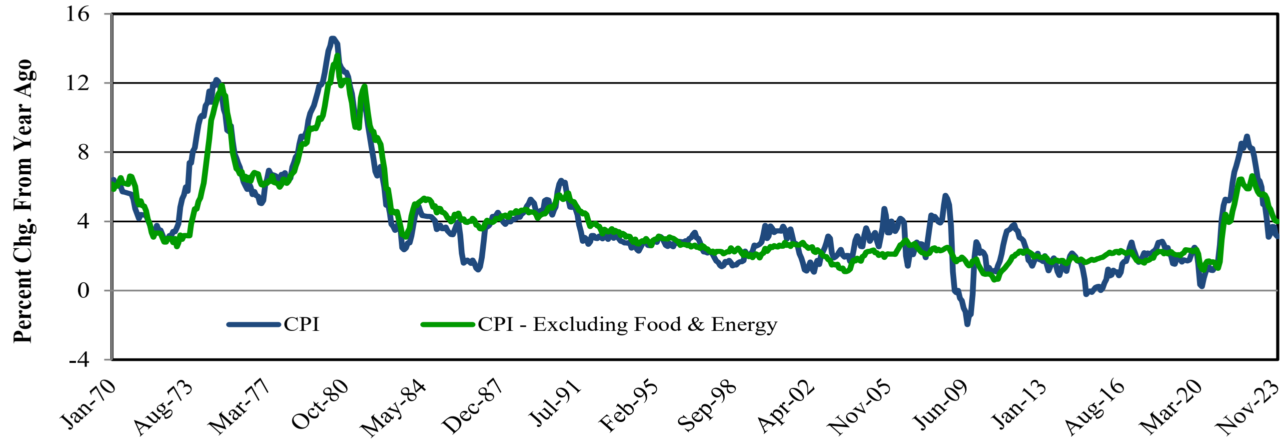
Source: Bloomberg



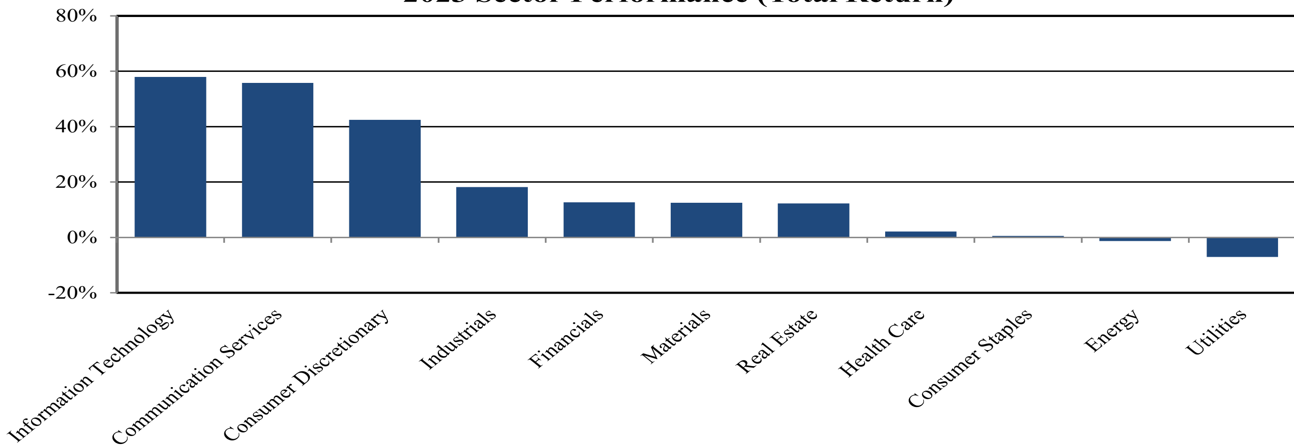
Source: Dow Jones & Company/Department of Energy



Source: Board of Governors of the Federal Reserve System



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



Source: Thomson Reuters Eikon

2024 OUTLOOK

The economy has witnessed three critical peaks: inflation, economic growth, and the Federal Reserve's policy interest rate. Historically, these dynamics have typically aligned with a broad peak in interest rates and a subsequent steepening of the yield curve. If inflation continues to subside and economic growth softens, central banks will begin to signal interest rate cuts, which should cause Treasury yields to drift lower.

Inflation should continue its decline in the coming year, pulled lower by falling shelter costs. The Zillow Rent Index, which measures the changes in new leases, currently reflects a 3.3% 12-month increase in shelter costs. This figure compares favorably to a 6.5% rise in shelter costs embedded in the latest

Consumer Price Index (CPI) reading, which is meant to reflect *all* existing leases rather than *new* leases. The shelter component of CPI is important as it comprises roughly one-third of the index. Though inflation should trend lower, we believe the era during which inflation tended to undershoot the central bank's 2% target and deflation risks occasionally emerged is likely over.

Economic growth proved higher than expected during 2023 as government spending and the drawdown of COVID-era excess savings offset the impact of meaningfully tighter monetary policy. With inflation falling, monetary policy is *still* tightening. We are unlikely to see a repeat of the 2023 economic tailwind, consisting of a doubling of the fiscal deficit - unprecedented outside of wartime - and broadly depleted excess consumer savings - particularly by lower income groups. Therefore, we anticipate economic growth will slow in 2024 due to falling consumer savings, plateauing wage gains, low savings rates, a softening labor market, less fiscal stimulus, and the lagged effects of high-interest rates. A critical risk to the year ahead is that the central bank must calibrate monetary policy perfectly when the economy reaches full employment. If it cuts interest rates too slowly, unemployment could rise; if it cuts rates too fast, inflation could rise. Monetary policy decisions will likely hold the key between tepid economic growth and a slight economic contraction over the next twelve to eighteen months. History also suggests that it is difficult to accelerate growth once the economy has reached full employment.

Interest rates are poised to fall around the world. Central banks rapidly increased policy rates to combat surging inflation in many countries. Domestically, the CPI has fallen by nearly two-thirds since its 9.1% peak in June 2022. With the Federal Reserve holding the upper end of its benchmark rate at 5.50% since July of 2023, any further decline in the inflation rate will result in further monetary tightening in *real* terms. Monetary policy's real – or inflation-adjusted – stance has the most significant impact on the economy. Any tightening of real monetary policy into softening economic growth will likely risk further economic expansion. Accordingly, central banks in most developed economies will probably loosen policy in the year ahead.

Politics will feature prominently in the headlines at home and abroad in the coming year. While the U.S. Presidential election will garner significant attention, there will also be critical elections in India, Indonesia, Mexico, and perhaps the U.K. While the outcome of these elections creates the opportunity for significant policy shifts, markets tend to overestimate the influence of policy shifts on long-term economic trends. Often, the effect of most policy shifts is uncertain and frequently overwhelmed by factors outside the control of governments. In our view, the most significant concern is that the world is passing through a period of peak globalization. The 1990s were a remarkable era of pro-market

globalization bookended by the fall of the Berlin Wall in 1989 and the acceptance of China into the World Trade Organization in 2001. While it is impossible to know what the future holds, we are witnessing the fracturing of the old order into two primary trading blocs. One bloc is anchored by the U.S., and the other by China. This global fracturing into a multipolar world will affect trade and global economic growth.

We anticipate corporate earnings for the Standard & Poor's 500 Index in 2023 will be essentially unchanged from 2022 once fourth quarter 2023 earnings are reported. This suggests that the 24.3% lift in the Standard & Poor's 500 Index in 2023, excluding dividends, was solely due to the expansion of the Price/Earnings ratio. The Price/Earnings ratio expanded in response to investors reducing both the odds of a recession and interest rates staying "higher for longer." Corporate earnings are forecasted to grow around 11% in 2024, which may prove optimistic. An economy can grow above potential if it is force-fed rapid credit growth or, as it turns out, massive fiscal stimulus. As the tailwind from excessive fiscal stimulus fades, it will be important for corporate profits to drive the equity market higher in the coming year. Most economic soft landings are derailed by an external shock, such as Iraq's invasion of Kuwait in 1990, which resulted in sharply higher energy prices. While the economy appears to be coming in for a soft landing, it will not take much of a wobble or external shock, such as the escalating turmoil in the Middle East, to tilt the economy into recession as economic growth likely slows in the year ahead.

*FINANCIAL MARKET TOTAL RETURN**

	Fourth Quarter 2023	Six Months Ending 12/31/23	One Year Ending 12/31/23	Annualized Return Two Years Ending 12/31/23	Annualized Return Three Years Ending 12/31/23	Annualized Return Five Years Ending 12/31/23
Standard & Poor’s 500 Index	11.69%	8.04%	26.29%	1.69%	10.00%	15.69%
Russell 2000 Index	14.03%	8.18%	16.93%	(3.55%)	2.22%	9.97%
Value Line Composite Index	10.73%	4.77%	12.94%	(4.08%)	3.50%	6.79%
Dow Jones Industrial Average	13.09%	10.72%	16.18%	4.02%	9.38%	12.47%
Nasdaq (OTC) Composite	13.84%	9.35%	44.70%	(1.18%)	6.08%	18.82%
Bloomberg Gov’t/Credit Intermediate Bond Index	4.56%	3.69%	5.24%	(1.73%)	(1.63%)	1.59%

** Total Return Includes Income*

Michael C. Yeager, CFA
January 7, 2024

IMPORTANT INFORMATION

The commentary set forth herein represents the views of Luther King Capital Management and its investment professionals at the time indicated and is subject to change without notice. The commentary set forth herein was prepared by Luther King Capital Management based upon information that it believes to be reliable. Luther King Capital Management expressly disclaims any responsibility to update the commentary set forth herein for any events occurring after the date indicated herein or otherwise.

The commentary and other information set forth herein do not constitute an offer to sell, a solicitation to buy, or a recommendation for any security, nor do they constitute investment advice or an offer to provide investment advisory or other services by Luther King Capital Management. The commentary and other information contained herein shall not be construed as financial or investment advice on any matter set forth herein, and Luther King Capital Management expressly disclaims all liability in respect of any actions taken based on the commentary and information set forth herein.