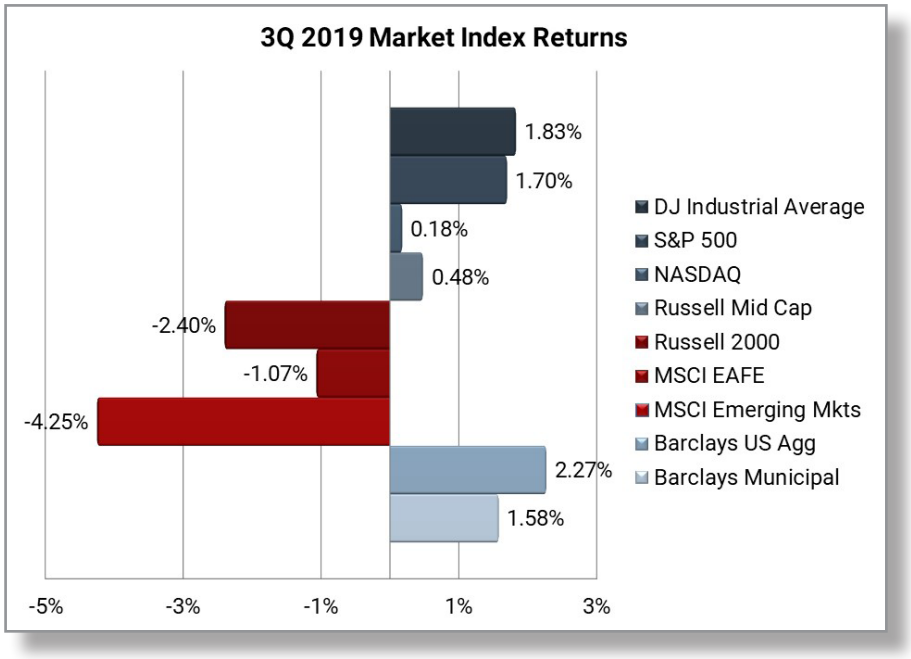
LINSCOMB WILLIAMS

WEALTH MANAGEMENT SINCE 1971

QUARTERLY MARKET COMMENTARY: *Third Quarter 2019*

the ECONOMY

For even a casual follower of the popular press or cable news, it's a fair bet that 2019 could be described as a bit hectic so far. But given the seemingly ever-present negative slant provided by the media, a remedying mental exercise is to take a break and tune out the day-to-day noise, and reflect upon some of the noteworthy historical achievements that have helped shape society today. As Linscomb & Williams approaches our 50th anniversary as a wealth manager – 48 years in business to be exact – we remember some important events that also recently hit the half-century mark, coinciding closely with our founding. Perhaps most extraordinary was the Apollo 11 mission, when Neil Armstrong became the first person to step foot on the moon on July 20, 1969. For those who prefer more earthly pursuits, say movies and television – just a few months after Apollo was when Butch and Sundance first dazzled us on the silver screen and The Brady Bunch and Sesame Street found their way into American living rooms. Long-time investors may recall 1969 as the year Walmart incorporated and opened its original distribution center in Bentonville, Arkansas -- a first step toward becoming the largest company in the U.S. by total sales. Or, if you just wanted to freshen up after a meal, have no fear, Tic Tacs had recently come to market (OK, so they were originally called "Refreshing Mints" ...we approve of the name change). Across the pond, the British were making contributions of their own. Sketch comedy show Monty Python's Flying Circus made its debut, and The Beatles released Abbey Road, the group's penultimate record and last in which all four members participated.



Speaking of records – the other kind though - the U.S. economy has set a new one, as the duration of the current expansion stretches into its 123rd month, the longest ever. Continued growth has been largely driven by a healthy labor market and a strong consumer. In fact, the unemployment rate recently hit 3.5 percent, the lowest in...wait for it...50 years. A broader measure of unemployment that includes people who are part-time but desire full-time work and those who haven't recently looked for a work, also fell to a cycle low of 6.9 percent. Given the dwindling number of unemployed, net job growth has slowed somewhat compared to 2018, but the average of 161,000 per month so far this year is plenty to keep up with population growth. Concurrent with solid employment has been a steady improvement in wages. Various measures put increases between 2.9 – 3.7 percent over the past year, ahead of overall inflation which is up 1.75 percent over the same time period. The combination of the above has buoyed consumer spending, which is by far the largest component of GDP, nearly 70 percent. Another developing bright spot is the housing market, which hadn't contributed much over the past 18 months. But whether it is natural demographic trends, slowing price increases, a lagged effect from lower mortgage rates, or some combination of the three, activity in this sector has picked up. Home builder confidence remains robust, and both new housing starts and new home sales just hit new cycle highs.

While the consumer is in good shape, business investment has been meager at best. Volatile commodity prices and weak global trade flows have been especially tough on the domestic manufacturing industries. The ISM Manufacturing survey, a gauge of business confidence, just fell to 47.8. Readings below 50 suggest the sector is contracting. Also, change in total industrial output is barely positive compared to a year ago. Those headwinds accounted for, the Federal Reserve estimates 3rd quarter GDP growth at close to 2 percent, only slightly below the average for this business cycle.

The story in Europe is similar with a relatively supportive consumer environment but depressed manufacturing and trade conditions. The unemployment rate in the 28-member European Union (EU) is now 6.2 percent, which is the best reading since the series started tracking in 2000. Retail sales volume is correspondingly at an all-time high. Global manufacturing and trade weakness have been particularly troublesome for the bloc's biggest economy, Germany, which is heavily dependent on exports. The country's manufacturing PMI fell to 41.7 in September, suggesting outright recessionary conditions. In the U.K., uncertainty surrounding ongoing Brexit negotiations appears to have taken a toll on the economy, though modest growth is still expected. The current deadline for the U.K.'s split from the EU is set for October 31st, but no concrete deal has yet been agreed upon.

Japan's economy has been slow but steady, though there is some worry about the consumption tax hike that took effect October 1st. But that increase has been well-known for some time, and Japanese stocks have performed well recently, led by cyclical and technology shares.

Emerging market assets have generated positive returns this year, but have generally trailed their developed world counterparts. Arguably a loss in confidence in the broad globalization theme has kept some investors on the sidelines, despite mostly stable country and corporate fundamentals. The primary issue of course is the on-again off-again trade negotiations between the U.S. and China. Further tariffs are

set to go into effect later this year should nothing change. But looking beyond China, there are some positive developments occurring elsewhere. India is cutting its corporate tax rate from between 30 – 40 percent down to 22 – 25 percent. In South America, though Argentina's recent political elections have been messy, neighboring Brazil is pushing toward much-needed pension reform and is considering privatizing a number of state-owned enterprises. One other interesting point is that, unlike the U.S. and Europe, manufacturing confidence amongst the aggregate emerging market complex is actually higher than it was at the beginning of the year.

CENTRAL BANKS

Over the course of 2019, we've mentioned the pronounced pivot in the way the Federal Reserve (Fed) was thinking about monetary policy – away from a belief that "neutral" interest rates were likely still higher -- towards the view that they may actually be somewhat lower than current levels. Well, now it's safe to say that the pivot has gone global. Though economic conditions around the world generally point to continued growth, central banks are clearly in a synchronized easing cycle at present with little signs of a change in course anytime soon.

In the U.S., the Fed cut interest rates another quarter-percentage point in September to its new range between 1.75 – 2 percent. Another decrease is expected before year-end. The European Central Bank (ECB) followed suit, reducing its key deposit rate 10 basis points to negative 0.50 percent, as well as restarting a quantitative easing program to be maintained for as long as it's deemed necessary. Outgoing ECB President Mario Draghi made a special plea to Eurozone governments at his final press conference, asserting that monetary policy stimulus may have reached its limits, and that fiscal programs and structural reform are what's needed to jump-start its members' economies.

With the developed world easing policy, emerging market central banks have the cover to do the same, and they've been quick to take advantage of the opportunity. Most notably have been large Asian economies India and China, both of which have significantly lowered borrowing costs this year.

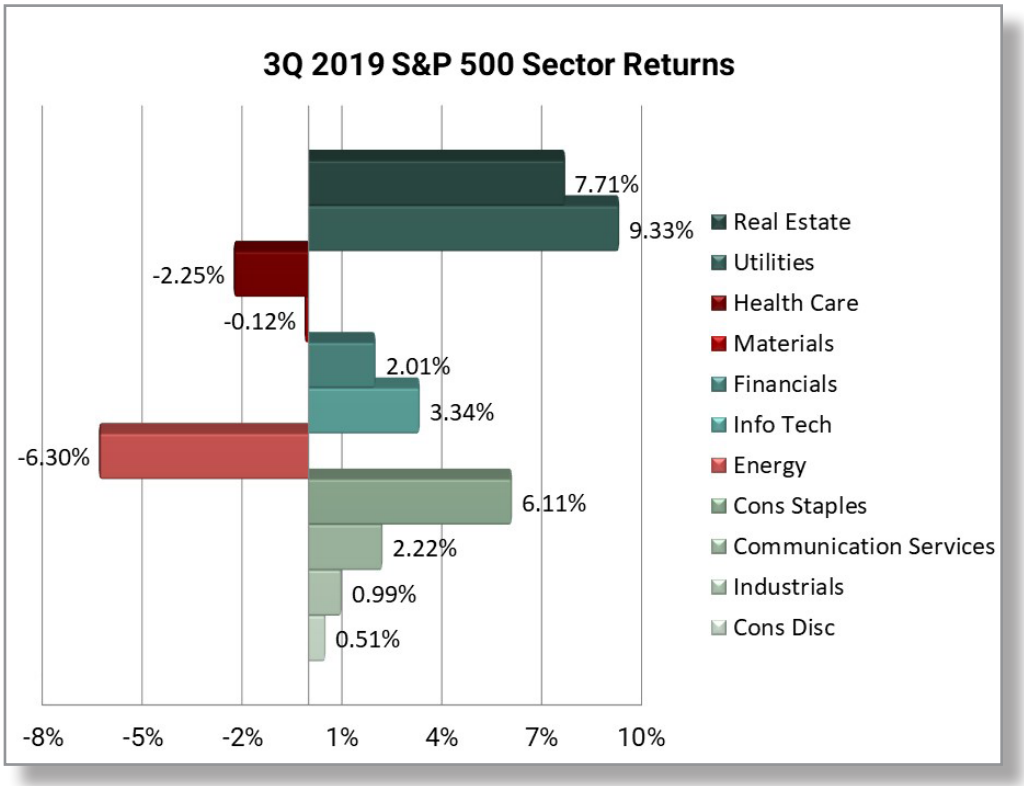
FIXED INCOME

Though there was a brief spike upwards in September, interest rates in general trended down further in the 3rd quarter. The 10-year U.S. Treasury yield opened in July a shade over 2 percent and ended the quarter at 1.68 percent. Falling rates were a global phenomenon, and at one point, the entire German government bond market (out to 30-year maturities) was sporting negative yields.

The prevalence of negative yielding securities is certainly unusual, but the good news for existing bond holders is that the decline in rates has led to excellent performance. Over the past 3 months, a basket of taxable investment grade bonds returned 2.27 percent, bringing the year-to-date gain close to 8.52 percent. Tax-free municipals also turned in solid performance, up 1.58 percent and 6.75 percent (not adjusting for tax benefits), respectively, over the same time periods.

Two risks in the fixed income market are worth noting. One, the amount of BBB-rated corporate debt outstanding -- the lowest rung that is still considered investment grade -- has increased markedly in recent years, leading some to believe

a wave of downgrades to junk status is a distinct possibility. While we are cognizant of this risk, Pacific Investment Management Company, one of the world's largest and most successful bond managers, points out that corporate fundamental debt metrics have been broadly improving throughout 2019. The other is the inversion, albeit brief, of the 2-year/10-year yield curve. Historically, instances in which the 2-year Treasury yield is higher than the 10-year have been harbingers of economic weakness. But, typically, the relationship needs to hold for at least a full quarter for the signal to be meaningful.



EQUITY

U.S. equity returns posted modest gains in the 3rd quarter, but it shouldn't be too surprising given the blistering first half of the year. The S&P 500 rose 1.70 percent, led by defensive sectors like utilities and real estate. Both have higher dividend yields than the overall market and tend to outperform when interest rates are falling. Three industry groups lost value – materials, energy, and healthcare. The first two suffered as commodity prices fell, and the latter has been weighed down by political risk all year. Legislation to reduce healthcare costs is one of the few ideas garnering bipartisan support in Washington. While yearly returns are still positive, international and emerging stocks had a down quarter, falling 1.07 percent and 4.25 percent, respectively. A marginally stronger U.S. dollar was a headwind to returns overseas.

Headline performance for U.S. stocks was rather staid overall in the 3rd quarter, but there was a lot of movement under the surface, especially in September. Investors hastily sold out of recent winners, which were mainly U.S. large cap growth stocks, and rotated into securities that had been laggards including small cap, value, and international shares. One month does not make a trend, but is something to keep an eye on going forward.

OUTLOOK

When discussing our outlook within the Investment Committee, another musical anniversary came to mind, though this one was only a 30th. It was in September of 1989 that Billy Joel's "We Didn't Start the Fire" came out, which eventually reached number one on the Billboard Chart. The

lyrics were relatively simple, a compilation of more than 100 headline events between 1949 (when Joel was born) and 1989 when the album was released. No doubt if Joel was re-recording the song, he'd have little trouble coming up with a list of worries, even if he was only focused on investment portfolios. Whether its impeachment inquiries, trade wars, protests in China, an attack on Saudi Arabia's oil supply, geopolitical frictions, negative interest rates, debt levels, or a new and untested "Modern Monetary Theory" gaining traction, there is plenty for investors to be concerned about. But perhaps Joel's point was that nothing is ever perfect, but we keep moving forward nonetheless.

Such is our stance on the global economy. There are risks we are monitoring to be sure, but on balance, our outlook is constructive. Domestically, the labor market remains in good shape and should continue to boost consumer spending. Prior to downturns, layoffs often start rising and employment growth usually slows materially, neither of which are occurring presently. A few additional spending stabilizers include the personal savings rate, which is well above its 25-year average, and overall household debt levels that are significantly lower than they were prior to the last recession. Consumer sentiment has moderated some with the political backdrop and more volatile stock market, but is still at elevated levels. Lower mortgage rates ought to support the recent pick-up in the housing market. On the corporate side, earnings growth rates have slowed compared to 2018's tax-cut induced surge, but are still expected to end the year in positive territory. CEO confidence has waned somewhat, likely as a result of heightened uncertainty surrounding trade policy, but current readings remain well above their levels ahead of the last downturn. To be sure, firms will likely be more cautious on the margin when it comes to new projects, but we don't foresee a material drop-off in capital expenditures. Growth in mature, international economies has decelerated, especially in countries geared toward manufacturing. But with their respective central banks providing additional monetary support and governments contemplating renewed fiscal stimulus, there is room for improvement. Given China's size and growth rates, many analysts consider it an economic swing factor. Not just for emerging markets, but for the global growth overall. Over the course of the year, both the Chinese central bank and government have implemented numerous policy measures to counteract trade-war induced slowdown. So, we'll be watching closely for evidence that this new stimulus is paying off.

From a stock market perspective, we would expect higher volatility to continue. Shorter-term movements in asset prices seem to be driven more by relatively unpredictable policy prognostications, trade-related or otherwise, as well as the general uncertainty caused by a changing geopolitical environment. But that in mind, the fundamentals still appear reasonably sound to us. Valuations are no longer cheap like they were at the end of 2018, but nor are they overly expensive, especially given the level of interest rates. Technical trends and market breadth are still positive, which has historically meant limited risk of material drawdowns in the near-term. Looking at bond market signals, the one major red flag – the aforementioned yield curve inversion – resolved itself rather quickly. Also, corporate credit spreads, which often widen out as the risk of a recession grows, are still very well contained.

We've had a great year so far, which naturally inclines investors to want to sell assets and "take chips off the table." But it is important to stick to a disciplined process and not

overreact to shorter-term market movements or news headlines. And, historically, when years start off above-average, they tend to finish that way as well. To be sure, financial and economic conditions are always changing, and we stand ready to adapt portfolios as needed in response and in accordance with our clients' unique situations.

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