LUTHER KING CAPITAL MANAGEMENT

FIRST QUARTER 2017 REVIEW

For eight years economic growth has largely been fueled by ultra-accommodative monetary policy that maintained interest rates near zero percent. As the Federal Reserve begins to withdraw monetary stimulus, the central bank is effectively handing the burden of economic growth to the White House and the Congress. The ability of fiscal policy to spur greater productivity will factor critically into achieving better economic growth. In the interim, readings of consumer confidence and business optimism reflect high expectations that serve as a bridge to better economic growth. These are important as economic data in the first quarter was not particularly strong and first quarter Gross Domestic Product (GDP) likely grew around 1.0%. Nevertheless, the expectation for lower taxes and lighter regulation has bolstered investors' outlook.

We expect the national conversation about taxes to intensify now that the topic of health care reform has been stymied for the moment. A great deal of attention will be focused on whether tax reform is achievable; the likely outcome is a tax cut. The U.S. stands alone among industrial countries as the only nation without a value-added tax (VAT). Paul Ryan has proposed a destination based cash-flow tax, often referred to as a border-adjustment tax (BAT), which is similar to a VAT. A shift from an income-and-profits-based approach of taxation to the inclusion of a new mechanism for collecting tax revenue is likely to result in intense deliberation. We remain positively disposed towards both corporate and personal tax reform; however, we believe short-term expectations should be tempered as the positive economic impact may be unlikely before 2018. The equity market is keenly focused on the issue of taxation and as a result, it will likely be highly sensitive to news that may affect the ultimate outcome. Lack of legislative progress could trigger a long overdue stock market correction.

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Despite a slow beginning to the year, real GDP growth for the full year should be higher in 2017 than the prior year. In addition, we anticipate a return to corporate earnings growth this year following three years of essentially flat results. Lackluster corporate earnings growth, combined with higher stock prices, has led to higher Price/Earnings (P/E) ratios for stocks. This multiple is a natural outgrowth of investors bidding stock prices higher in anticipation of better future corporate earnings growth. The equity market as measured by the Standard & Poor's 500 Index gained 11.3% from Election Day through the end of the first quarter this year, with 6.1% of the gain occurring this year.

ECONOMY

Some market observers have characterized the U.S. economy as being in a "Goldilocks" phase, where it is growing neither too slow to risk recession nor too fast to require a sharp increase in the pace of interest rate hikes. In many ways this is a very apt description. While economic growth has been far from robust, averaging around 2.0% real annual growth for years, there has been a shift in the direction in which the economy's growth leans. In recent years there have been periods in which deflation, rather than inflation, was the primary concern. Deflation, or falling price levels, can be more insidious than inflation in many ways. Once deflation takes hold, as it did from 1929 through 1933 when consumer prices fell by 23%, it is difficult to combat. As workers lose their jobs, they reduce spending in order to service their fixed costs such as mortgages and rent payments. Consumers and businesses become accustomed to price declines. As a result, they expect to purchase goods in the future more cheaply and further curb spending. At the same time, consumers' inclination to borrow falls as they anticipate debts to be repaid with deflated dollars in the future, rendering debt more expensive. In our opinion, deflation was possible, but certainly not very probable. Nevertheless, it explains a great deal of the Federal Reserve's behavior over the past eight years.

The Federal Reserve might well be further down the path of normalizing interest rates if not for the 75% decline in crude oil prices from mid-2014 through February 2016. A material decline in gasoline prices paid at the pump typically behaves as a "tax cut" for consumers, spurring consumer spending on other goods and services. However, a negative feedback loop developed in which commodity prices fell and with them inflation expectations. This dynamic resulted in higher real yields, tighter monetary conditions, a flatter yield curve, and slower economic growth. Despite continued tepid economic growth, inflation readings and expectations are beginning to firm. If the labor market continues to tighten through 2017 and other economic data improves, it is likely the Federal Reserve will increase the target Federal Funds rate at least one additional time this year.

The Federal Reserve has been slow to raise interest rates for fear of truncating fragile economic growth. Importantly, the central bank has not been compelled to ratchet rates higher in response to accelerating inflationary pressures as in a typical economic cycle. This reluctance is due in part to only moderate upward pressure on wages despite the unemployment rate having fallen to 4.5%. The last time that the unemployment rate was this low was May 2007, and the Federal Funds rate was 5.25% compared with 1.00% today. The economy has created 2.4 million jobs over the previous 12 months, while the labor force grew precisely half that amount. If this trend continues, the unemployment rate should fall further. The primary friction to the unemployment rate falling at a faster clip is the steady flow of people rejoining the labor force, known as the labor force participation rate. In our conversations with corporate management teams, the discussion is increasingly steered towards the challenge they face in finding qualified labor. We are closely watching the labor market for signs of wages strengthening.

On the fiscal policy front, the Congressional leadership and White House now pivot from health care to taxes. A central question will be whether senior leadership attempts tax reform or tax cuts. Tax reform is clearly more comprehensive in scope, but also more difficult to achieve. The Congress and administration were last able to accomplish tax reform under President Reagan in 1986. This reform required a "lower-the-rate-broaden-the-base" approach. A repeat of this refrain is unlikely in our view because popular tax breaks such as mortgage interest, state and local taxes, retirement savings, and employer-sponsored health insurance would potentially be placed on the chopping block. The workaround would be to shift from an income tax to a consumption tax. A wholesale shift to a consumption tax, such as a VAT employed by many European countries is likely untenable. Instead, a destination based cash-flow tax, the BAT referred to earlier, has been proposed as an important aspect of tax reform. Both the theoretical aspects and the complexities of the BAT make it unlikely to survive the House dissection, and even less likely in the Senate. The path of least resistance, and therefore more likely, is simply tax cuts. The Congress passed significant tax cuts in 1981 and 2001 with smaller reductions in 2003, 2009, and 2010.

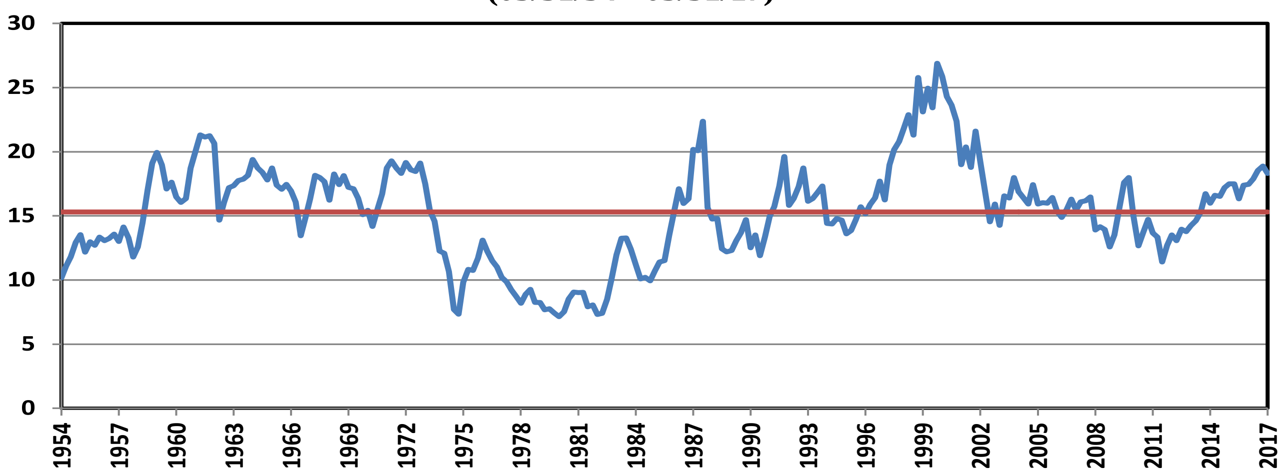
Whether the outcome is tax reform or tax cuts, the specter of the rising federal budget deficit will be a keen area of focus. In fiscal year 2016, the federal budget deficit increased in proportion to economic output for the first time since 2009. The Congressional Budget Office (CBO) updated its economic forecast at the end of the first quarter 2017. The CBO estimates the 2017 budget deficit to be $559 billion, or 2.9% of GDP. It is the accumulation of annual deficits which may not sit well with lawmakers. The CBO forecasts that public debt, which represents 77% of GDP in 2017, will rise to

89% by 2027. It is important to note the forecast by the CBO assumes that current laws governing taxes and spending will generally remain in place. As a result, the forecast is meant to be a guidepost for lawmakers and a yardstick against which to measure potential fiscal changes.

CAPITAL MARKETS

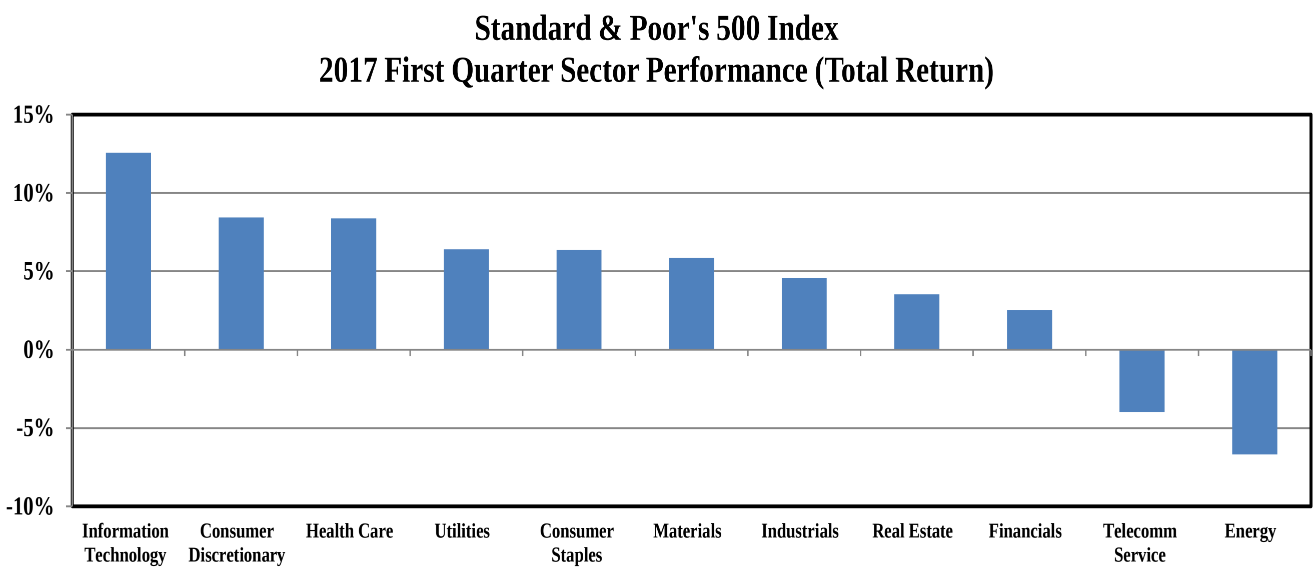
Four important factors that can influence P/E multiples are: taxes, regulation, interest rates, and inflation. Lower taxes and lighter regulation are clearly being discounted by investors as they patiently await good news from Washington. Although the Federal Reserve has begun to tighten monetary policy this cycle, one interest rate hike each of the past two Decembers and a third in March of this year are not overly burdensome. Further, the market interest rate on the 10-Year U.S. Treasury note ended the first quarter at a modest 2.39% yield. Finally, core inflation as measured by the Consumer Price Index, less the more volatile food and energy components, reads a reasonable 2.2% currently. While inflation pressures are firming, they remain short of inciting a rapid rise in interest rates. Taking the four components collectively, it is little surprise that the P/E ratio for the Standard & Poor's 500 Index has risen to 18.1 times the estimated $130/share in earnings for 2017. The following chart contains the P/E ratio of the Standard & Poor's 500 Index since 1954. The average over this time period is 15.3 times. The sustained period of a low P/E ratio from 1973 through mid-1980's was marked by high inflation and a yield on the 10-Year U.S. Treasury note of 15.8%.

Standard & Poor's 500 Index
Price/Earnings Ratio*
(03/31/54 - 03/31/17)



* Forward P/E ratio beginning 03/31/90
Source: Bloomberg

Nine of the eleven sectors of the Standard & Poor's 500 Index climbed during the first quarter. Shares of technology companies traded higher during the first quarter, as expectations for better economic growth resulted in growth-oriented stocks outperforming value-oriented stocks during the first quarter. Health care benefited from the potential repeal of the ACA, and consumer stocks performed well as consumer confidence remains high and employment data remain strong. Conversely, the energy sector trailed the general market as the price of crude oil slid nearly 5% during the quarter on higher than expected OPEC production and domestic drilling activity.



Source: The Thomson Corporation

We remain constructive on the equity market, and an expectation of future interest rate hikes frames our desire to maintain relatively short durations in bond portfolios at this time. As we noted in our 2017 Outlook, the current business cycle is long-lived by historical standards. As the year continues to unfold, we anticipate the economy will exhibit characteristics typical of a late stage business cycle including tightening labor conditions, firming inflation, and peak profit margins. Corporate earnings growth should support the market in 2017, and positive news related to fiscal policy could generate further upside movement.

CONCLUSION

A combination of an anticipated tax reduction or lighter-handed regulation, increased infrastructure spending, and a cash repatriation tax holiday provide an optimistic backdrop for higher corporate earnings in 2017. U.S. dollar strength and the prospect of higher interest rates may prove to be modest headwinds, though not a significant impediment to corporate earnings growth. There will be further surprises this year, and an exogenous geopolitical shock to the economy continues be one of the most significant risks to market prices.

The famous investor Sir John Templeton once quipped, “Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria.” The Standard & Poor’s 500 Index appreciated 31% from mid-February 2016 through the beginning of March this year, as pessimism around economic growth gave way to optimism. It will be necessary for economic data to continue to improve and progress to be made in areas of fiscal policy to sustain this market cycle.

*FINANCIAL MARKET TOTAL RETURN**

	First Quarter 2017	**Six Months Ending 03/31/17**	**One Year Ending 03/31/17**	**Annualized Return Two Years Ending 03/31/17**	**Annualized Return Three Years Ending 03/31/17**	**Annualized Return Five Years Ending 03/31/17**
Standard & Poor’s 500 Index	6.07%	10.12%	17.17%	9.21%	10.37%	13.30%
Russell 2000 Index	2.47%	11.52%	26.22%	6.72%	7.22%	12.35%
Value Line Composite Index	3.30%	8.63%	17.10%	2.87%	3.74%	9.17%
Dow Jones Industrial Average	5.19%	14.30%	19.91%	10.64%	10.61%	12.15%
NASDAQ (OTC) Composite	10.13%	12.00%	22.95%	11.22%	13.51%	15.38%
Bloomberg Barclays Capital Gov’t/Credit Intermediate Bond Index	0.78%	(1.30%)	0.42%	1.24%	2.01%	1.88%

* *Total Return Includes Income*

Michael C. Yeager, CFA
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IMPORTANT INFORMATION

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