LUTHER KING CAPITAL MANAGEMENT

SECOND QUARTER 2017 REVIEW

The economy remains sound as evidenced by low unemployment, tame inflation, historically low interest rates, and improving corporate profits. In addition, the potential for fiscal stimulus in the coming quarters could contribute to additional economic growth. In response to these conditions and the supposition of their near-term continuation, the equity market rose 9.3% during the first half of the year as measured by the Standard & Poor's 500 Index. The expectations of consumers, corporations, and investors rose dramatically following the election last fall. However, optimism has been somewhat tempered by the inability of Congress to resolve the issue of healthcare reform before moving on to much-desired fiscal policy, including tax reform.

Against this backdrop, the government is attempting a "handoff" from tighter monetary policy to stimulative fiscal policy. However, this handoff is not precise and the calibration is extraordinarily difficult. As a first stage, the Federal Reserve began raising interest rates in December 2015, with an additional increase in December 2016, followed by two additional interest rate hikes in March and June of this year. Concurrently, the central bank is charting the best course of action to begin reducing the size of its $4.5 trillion balance sheet. How the capital markets will adjust to a tightening of monetary policy remains a key focus for investors.

We forecast corporate profits to grow at a nearly double-digit rate in 2017, driven by strong earnings growth within the technology sector, as well as a rebound in the earnings of energy companies. In addition, the U.S. dollar, which weakened 6.6% in the first half of the year, is currently a tailwind for corporations that generate earnings abroad. Following only 1.4% growth in real Gross Domestic Product (GDP) in the first quarter, we expect the second quarter figure will reflect a near doubling of first quarter economic growth.

LKCM
LUTHER KING CAPITAL MANAGEMENT

ECONOMY

The current economic expansion has entered its ninth year, making it the third longest in the post-war era. Some market observers have used "the Goldilocks analogy" for the current economic environment. Economic growth is neither hot (fast) enough to spur faster monetary tightening, nor cold (weak) enough to question its near-term sustainability. Indeed, the economy's tepid annual growth of around 2% may be the source of its continued longevity. Recent hawkish comments from members of the Federal Reserve Open Market Committee responsible for setting the benchmark interest rate has raised the prospect of a possible monetary policy error: an over-tightening of monetary policy. We believe this is unlikely, but not impossible.

The Federal Reserve Bank is tasked with managing monetary policy to satisfy its "dual mandate" of achieving full employment and price stability. With an unemployment rate of 4.3%, a level last registered in May 2001, the economy is at full employment unless the labor participation rate rises further. With regard to price stability, the Federal Reserve's preferred measure of inflation is currently indicating annual inflation of 1.7%, and only 1.5% excluding the more volatile components such as food and energy, well below the 2.0% level which is often regarded as the target level. As a result, the Federal Reserve Bank appears to be pursuing a "dual desire" of reducing its $4.5 trillion balance sheet and ratcheting interest rates sufficiently high enough to allow the Bank room to reduce rates in response to the eventual end of the current business cycle.

One of the policy tools employed by the Federal Reserve to create an economic rebound during the Great Recession was Quantitative Easing, which involved the purchase of U.S. Treasury securities and Mortgage Backed Securities (MBS). The goal was to pull demand forward via credit creation by keeping long-term rates very low. The end result left the central bank owning $4.5 trillion of fixed income securities, an amount equivalent to about a quarter of America's annual GDP. By holding yields low, consumers could borrow for items such as homes and autos at low interest rates. Additionally, the U.S. government could finance its budget deficits at low rates of interest. There were other pro-cyclical benefits such as allowing companies in emerging markets that borrow in U.S. dollars, including China, to do so at extremely low interest rates. Although somewhat controversial, there is a theory that by pushing the price of bonds higher through central bank purchases, investors were enticed to purchase equities at a more attractive relative value. The questions the Federal Reserve is grappling with are how, when, and at what rate should its balance sheet be reduced?

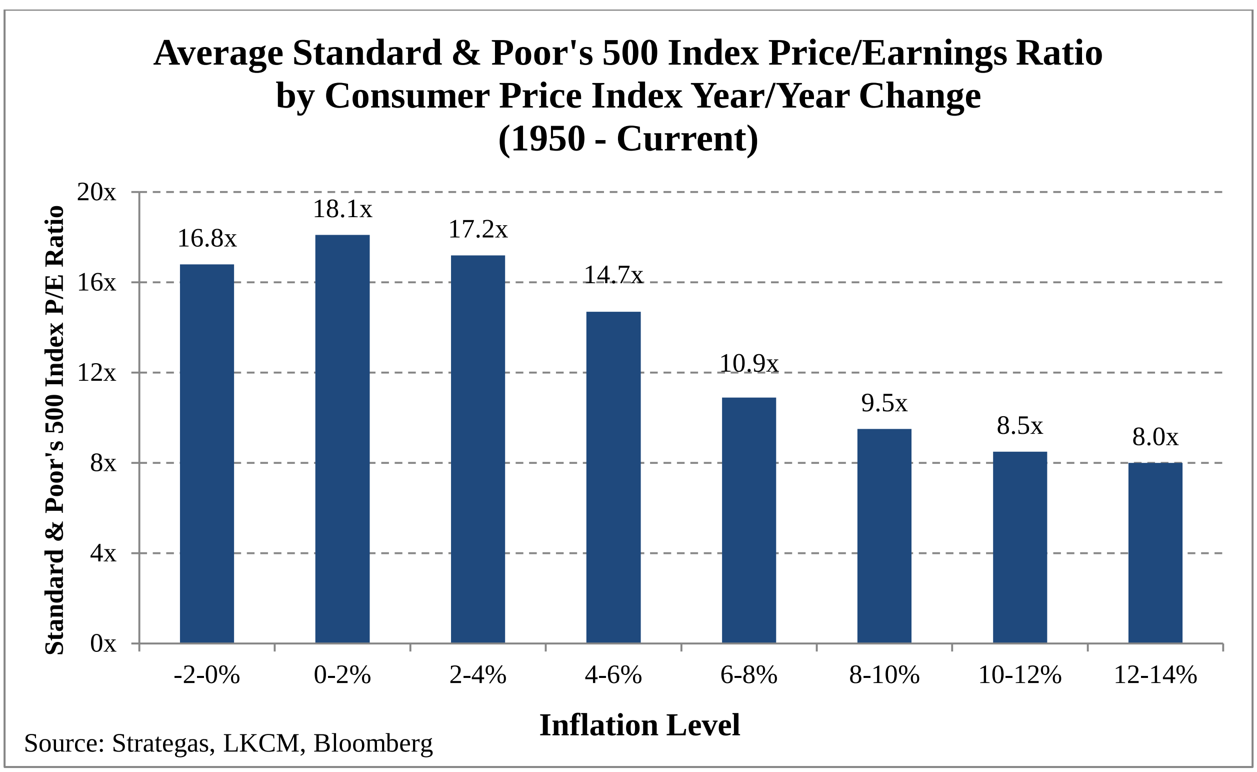
The Federal Reserve has begun to publicly discuss an outline of a plan for reducing its assets by simply allowing fixed income securities to mature without reinvesting the proceeds. The plan the central bank has put forward would allow $6 billion of U.S. Treasury notes and $4 billion of MBS to mature monthly with the intention of gradually increasing the amount of maturities not reinvested over time. Given the relatively small incremental approach, the bond market thus far appears comfortable that financial conditions are not going to tighten severely as a result. This is in stark opposition to the bond market's reaction to then-Federal Reserve Chairman Ben Bernanke's suggestion in May 2013 that the central bank was considering scaling back, or tapering, its bond purchases. The yield on the 10-Year Treasury note nearly doubled in 2013 as a result of Ben Bernanke's comment, a period often referred to as the "taper tantrum."

In addition to parsing Federal Reserve guidance, there will be more national discussions with regard to the national debt. The U.S. government currently spends more money than it brings in through revenue with the balance covered through new borrowing. This year tax revenues have been running 2%-3% less than forecast, which Treasury Secretary Mnuchin attributes to expectations for future tax reform. Indeed, we have been cognizant in client portfolios to allow for the possibility of a lower tax schedule in 2018. The government may only issue debt up to a certain limit, or ceiling, established by Congress. The debt ceiling has been permanently raised, temporarily extended, or the definition of the debt limit revised a total of 78 times since 1960. This process attracts news headlines, but rarely upsets the capital markets. However, the debt ceiling debate in 2011 and partial government shutdown in October 2013 did garner the capital market's attention.

The level of national debt is likely also to remain in the public eye given the Congressional Budget Office's (CBO) recent update which revised higher the annual budget deficit for each year of the coming decade. As a result of growing yearly shortfalls, the federal deficit is projected to top $1 trillion in 2022. By the end of the decade, the forecast calls for debt held by the public to reach 91% of GDP, the highest level since 1947 and twice the average level of the past fifty years. While CBO forecasts are routinely revised based on updated model assumptions, the topic of debt may garner more market attention in the future.

CAPITAL MARKETS

The equity market and the bond market have been at odds during the second quarter over the future path of inflation. Stock prices rose steadily during the quarter spurred on by the 13.6% corporate earnings growth in the first quarter. The bond market rose as well during the quarter, sending yields lower. Two intriguing trends have developed within the bond market during the first half of the year. First, the spread between yields on nominal Treasury instruments and the yield on their corresponding Treasury Inflation Protected Security (TIPS) continued to narrow. The amount of spread between these two government-backed securities can be interpreted as the bond market's implied forecast of future inflation. For example, the yield between the 5-Year Treasury note and the 5-Year TIPS has narrowed to 1.86% from 2.04% at the beginning of the year. Therefore, the bond market has grown increasingly skeptical about the prospect for higher inflation. Indeed, the most recent readings of inflation have fallen. It is uncommon for the Federal Reserve Bank to be increasing its target Federal Funds rate, as it did in March and June of this year, at a time when inflation expectations are falling. Historically, low inflation has been supportive of higher Price/Earnings multiples as illustrated by the following chart.



The second intriguing trend in the bond market during the quarter was the flattening of the yield curve, or a narrowing of the yield spread between long-dated Treasury bonds and short-dated Treasury bills. The longer the duration of a bond, the greater its sensitivity to changes in economic expectations. Therefore, when investors hold a positive view of economic growth, the price of the 30-Year Treasury bond generally declines, pushing yields on the long end of the yield curve higher. This behavior leads to a steeper yield curve and is viewed as a positive backdrop for interest rate sensitive sectors of the economy such as banks. Conversely, when bond investors grow increasingly less optimistic about economic growth, they bid the price of bonds higher, pushing yields lower. This generally results in a flatter yield curve, all else being equal. In the current environment, the Federal Reserve Bank is increasing the target Federal Funds rate, which acts to lift yields on the short end of the yield curve.

The curve spread between the 2-Year Treasury and the 10-Year Treasury closed the quarter at 0.92%, down from 1.25% at the beginning of the year. A flattening of the yield curve is consistent with the latter stages of a business cycle. If the Federal Reserve Bank continues to raise short-term interest rates and the long end of the curve does not move higher, then the yield curve will invert. This would likely be viewed as an unforced error in monetary policy. The most surprising outcome may well be that inflation remains stable and therefore interest rates remain low. This environment would continue to be supportive of equities, especially when combined with the potential for fiscal stimulus.

The valuation of the equity market has garnered recent attention among investors, which typically coincides with new market highs. In the short run, there is little relationship between the Price/Earnings ratio of the Standard & Poor's 500 Index and its subsequent twelve month return. The level of the market's Price/Earnings ratio is influenced by structural forces such as the weighting of the eleven sectors within the Standard & Poor's 500 Index, long-term earnings growth rate expectations, and fiscal policy. Often the changes of Price/Earnings ratios within a year are heavily influenced by cyclical forces such as inflation trends, credit spreads, and other economic data such as employment figures and manufacturing data.

Inflation readings, market-based inflation expectations, and falling oil prices this year suggest inflation is unlikely to abruptly shift to a higher level, prompting the Federal Reserve to accelerate its moderate pace of monetary tightening. As a result, current Price/Earnings ratios are not a prominent near-term concern. However, the Price/Earnings ratio of 18.5X estimated annual earnings for the Standard & Poor's 500 Index indicates that the majority of prospective market appreciation is likely to be derived from healthy corporate earnings growth rather than multiple expansion.

The largest near-term threat to the equity market is a misstep in monetary policy by tightening too quickly. The Federal Reserve's guidance is for one additional interest rate hike of 0.25% in 2017 and an additional 0.75% of tightening in 2018 in 0.25% increments. In conjunction with the anticipated announcement of the Federal Reserve's balance sheet reduction, this amounts to a substantial monetary tightening in the coming six quarters. While economic data is sound, it is historically much stronger at this point in the business cycle when the central bank begins its tightening process. Therefore, the Federal Reserve may have to be more flexible in the course it currently has plotted.

CONCLUSION

A synchronized global economic recovery remains on course, with low core inflation readings in most economies. This allows central banks to remove monetary stimulus at a very gradual pace. Deflation fears have faded and, with falling jobless rates, it is unlikely that deflation concerns will be renewed. Early signs of lighter regulation have begun to emerge in areas such as banking. The lackluster pace of economic growth and lack of inflationary pressures provide the Federal Reserve room to maneuver and potentially reduce the size of its balance sheet as it gradually increases interest rates.

Following two years of essentially no corporate earnings growth, 2017 is expected to deliver earnings growth of 8%-10%. This is supportive of equity prices and has already been partially discounted by the equity market this year. We continue to favor equities over fixed income, given the potential for interest rates to rise further over the coming quarters.

*FINANCIAL MARKET TOTAL RETURN**

	Second Quarter 2017	Six Months Ending 06/30/17	One Year Ending 06/30/17	Annualized Return Two Years Ending 06/30/17	Annualized Return Three Years Ending 06/30/17	Annualized Return Five Years Ending 06/30/17
Standard & Poor's 500 Index	3.09%	9.34%	17.90%	10.73%	9.61%	14.63%
Russell 2000 Index	2.46%	4.99%	24.60%	7.80%	7.36%	13.70%
Value Line Composite Index	0.76%	4.08%	15.94%	4.13%	3.15%	10.78%
Dow Jones Industrial Average	3.95%	9.35%	22.12%	12.97%	11.01%	13.45%
NASDAQ (OTC) Composite	4.21%	14.76%	28.40%	12.39%	13.11%	17.47%
Bloomberg Barclays Capital Gov't/Credit Intermediate Bond Index	0.94%	1.73%	(0.21%)	2.03%	1.92%	1.77%

** Total Return Includes Income*

Michael C. Yeager, CFA
July 5, 2017

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.