LUTHER KING CAPITAL MANAGEMENT

THIRD QUARTER 2017 REVIEW

The domestic economy continues to grow at a moderate pace supportive of continued corporate profits growth. Following real economic growth of 1.2% during the first quarter, the economy advanced 3.1% in the second quarter. The impact of hurricanes Harvey and Irma during the third quarter was felt by millions, including clients, friends, and family. It will take years to fully rebuild and recover from the havoc of these two storms. The dip in retail sales, industrial production, homebuilding, and home sales in August was certainly influenced by the two storms and as a result, economic growth for the third quarter will likely fall short of the advance registered in the second quarter.

In the latter stages of the business cycle it is typical for the Federal Reserve to raise interest rates in response to the threat that rising wage pressures will spur broader inflationary pressures. Wage growth of 2.5% today remains well below the level historically linked to the current low unemployment level. In fact, this observation is the focal point of a good deal of current economic research and commentary. One explanation is that there is simply greater labor market slack than currently expressed through employment data.

The Federal Reserve has been slow to increase short-term interest rates this year in part due to the lack of immediate inflationary pressures. Having raised the Federal Funds rate by 0.25% in March and June, the central bank is unlikely to raise interest rates until possibly its December meeting. As a result of this measured pace of monetary tightening, financial conditions have actually eased during the year with falling bond yields, tightening credit spreads, and a weaker U.S. dollar. Against this backdrop, the Standard & Poor's 500 Index advanced 4.5% during the third quarter and 14.2% for the first three quarters of the year.

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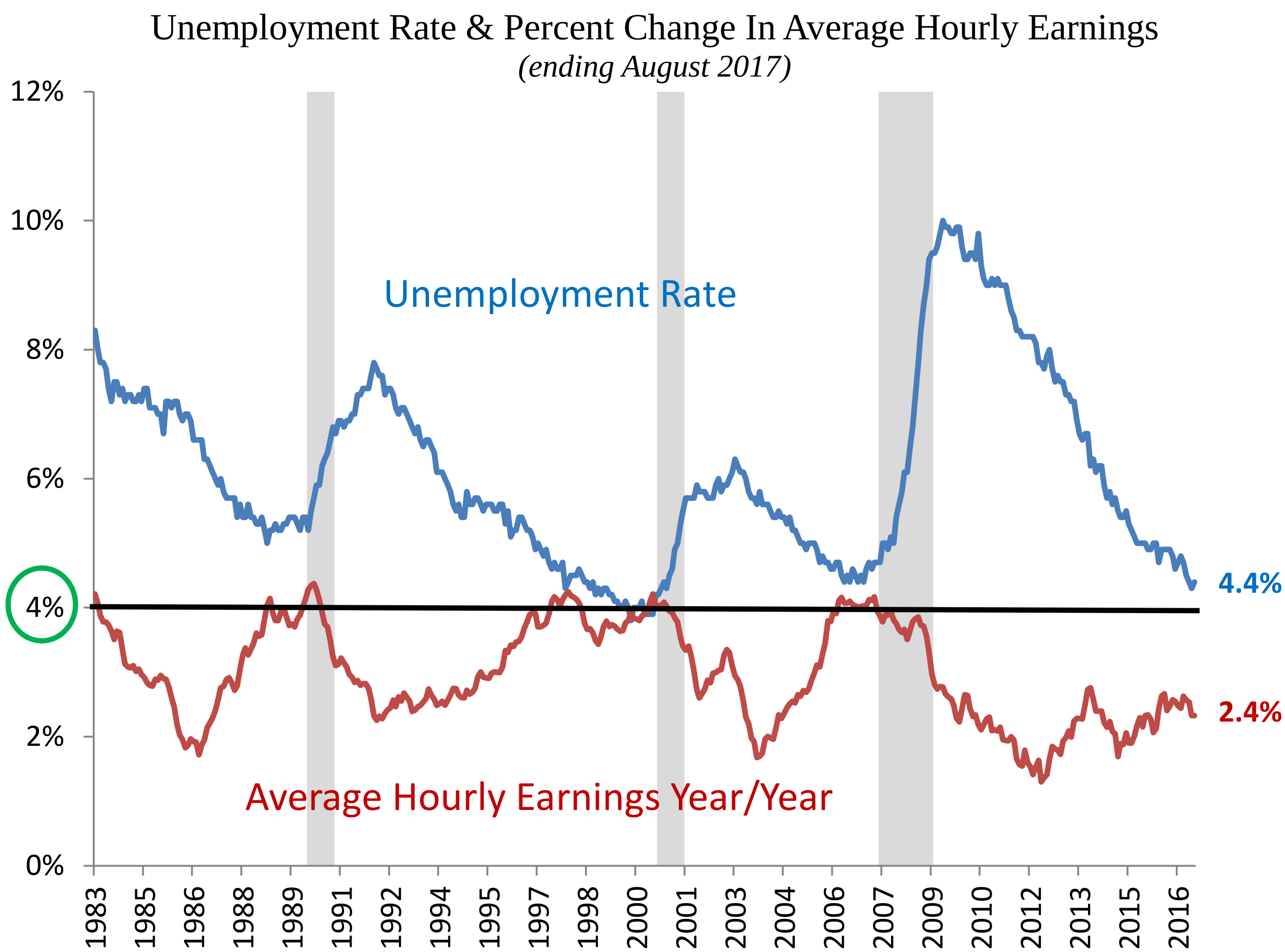
ECONOMY

The current U.S. economic expansion has now reached nine years, making it the third longest in the post-war era. The March 1991 – March 2001 expansion was marked by extensive spending on technology culminating with the Dot-Com Bubble. Prior to this late 1990's expansion, the longest expansion was from February 1961 – December 1969 when employment rose by one third and incomes expanded considerably. There was expansive fiscal policy driven by the Vietnam War, and the cost of this expansion was rising inflation as the 1960's drew to a close. As the adage suggests, expansions do not die simply of old age. Rather, they are typically brought to an end by some combination of monetary tightening and unwinding of the imbalances that build up during the boom years.

There are certain parallels with today's environment and that of the 1960's. Analogous to today, inflation hovered below 2.0% in the first half of the 1960's even though the rate of unemployment was falling. However, once the unemployment rate fell below 4.0%, the core inflation rate rose from 1.5% in early 1966 to nearly 4.0% in 1967. As the economic gap between GDP and potential GDP has recently narrowed, history would suggest that wage growth should increase as the unemployment rate falls, as seen in previous economic cycles in the graph on the following page. Thus far, the annual percentage change in average hourly earnings has stalled, which leads to three key observations. First, temperate wage growth has contributed to lower overall inflation and has led the central bank to only modestly increase interest rates, which has elongated the current business cycle. Second, corporate profit margins have remained elevated and near all-time highs. Between 2000 and the second quarter of 2015, the share of corporate income that went to workers' wages, instead of accruing to the owners of capital, declined from 82.3% to 75.5%. Over the past several decades secular forces have contributed to labor's lower share of corporate income, including technological innovation and the entry of hundreds of millions of workers into the global workforce through freer global trade. Finally, the lackluster wage growth has contributed to rising income disparity domestically.

The graph on the following page illustrates the relationship between a falling unemployment rate and rising average hourly earnings. In recent history, as the unemployment rate nears 4.0%, average hourly earnings growth has accelerated to around 4.0%. In the current economic expansion, the unemployment rate has fallen from 10% after the Great Recession to a level of 4.2% today, while wage growth has stalled at 2.5%. In terms of economic growth, higher wages lift household spending which represents the largest segment of the economy.



Note: Average hourly earnings is a three month moving average
Recession periods shaded

Source: Bureau of Labor Statistics, Bloomberg, LKCM

The trajectory of inflation and the central bank's response will likely be the two most significant determinants of the longevity of the current economic expansion. Although the Federal Reserve did not increase interest rates at its September meeting, the central bank did announce its intent to reduce the size of its $4.5 trillion balance sheet beginning this month. Over the course of three asset purchase programs beginning in 2008, commonly referred to "Quantitative Easing", the Federal Reserve purchased U.S. Treasury securities and Mortgage Backed Securities (MBS) with the goal of further easing financial conditions thereby stimulating economic demand. The Federal Reserve's plan is to begin the orderly reduction of its balance sheet with maturities, only reinvesting to the extent it does not exceed gradually rising caps. The initial cap will be $6 billion for U.S. Treasury securities with the cap rising by $6 billion every three months, thereby reaching $30 billion at the conclusion of a year. Similarly, the initial cap for MBS will be $4 billion with the cap rising by $4 billion every three months until a cap of $20 billion is reached over twelve months. Thus the initial annual run-off will be less than 1.0% of the current balance sheet, rising to an annual run-off of just over 4.5%.

The economic impact of reducing the Federal Reserve's balance sheet is a tightening of financial conditions. The central bank likely believes that clear communication and near negligible amounts of amortization is a sound beginning point. According to the New York Federal Reserve Bank's estimates, the balance sheet reduction should be completed early in the next decade. In recent years, the Federal Reserve has become purposefully transparent about its interest rate expectations by publishing a forecast, as well as hosting a press conference quarterly. Significant turnover in the leadership of the Federal Reserve is potentially overshadowing this guidance in the near-term. Federal Reserve Vice-Chair Stanley Fischer recently announced that he is stepping down from his position this month. Once Fischer vacates his position, there will be four vacant positions on the seven member Federal Reserve Board of Governors. However, Randal Quarles, a former Treasury official, has been nominated by President Trump, was recently confirmed by the Senate, and should soon join the Board of Governors. Further, the four-year term of Chairwoman Janet Yellen expires in February. There is considerable speculation concerning whether President Trump will reappoint Janet Yellen as Chairwoman. If she is not reappointed, she will most certainly step down from the Board of Governors, creating yet another vacancy. The Board of Governors not only sets the tone for bank supervision, but also constitutes the core of the interest rate setting Federal Open Market Committee, which also includes the President of the New York Federal Reserve Bank and four of the other eleven regional Federal Reserve Bank presidents. The current Federal Open Market Committee has been dovish towards interest rates, and investors will be watching closely for any change in tone.

CAPITAL MARKETS

Major U.S. equity benchmarks including the Standard & Poor's 500 Index, the NASDAQ Index, and small-company focused Russell 2000 Index all recorded new highs on the final trading day of the third quarter in 2017. Rising expectations for tax reform contributed to the significant increase in equity prices in September. Equity prices of small companies rallied 6.1% in September as measured by the Russell 2000 Index. Small companies as a group generate a greater percentage of their revenue domestically, making them greater beneficiaries of a reduction in corporate tax rates.

It is difficult to handicap the reduction in corporate tax rates, if any, in part because the recently presented framework is incomplete. The initial overture has tax decreases, but few revenue or spending offsets. This approach would likely widen the deficit in the short-run, alienating deficit hawks. President Trump appears to have the initial support of the House Ways and Means Committee, as well as the Senate Finance Committee, which serves in contrast to the level of support for the repeal and replacement of the Affordable Care Act. Even more immediate, Congress must pass a budget resolution, which is likely to occur prior to the end of October. Tax cuts in the latter stage of the business cycle should be inflationary, which is why bond yields rose, the yield curve steepened, and the U.S. dollar appreciated in September as the potential for a tax plan came into focus.

Through the end of the third quarter, growth stocks have outperformed their value stock peers by 11.9% within the Standard & Poor's 500 Index, which is consistent with the later innings of an equity market cycle. Historically, value stocks tend to outperform very early in an equity market cycle, and growth typically performs better in the mid-to-later stages of the cycle. As we discussed previously, wages normally begin to rise late in the economic cycle, which pressures corporate profit margins. When corporate profit margins are wide across the entire economy, there is essentially a tailwind for all companies. However, as profit margins come under pressure later in an economic cycle, growth becomes increasingly scarce, and investors typically pay a premium for companies that can grow above the average.

Turning to the fixed income market, the yield on the benchmark 10-Year U.S. Treasury bond fell from a high of 2.39% to a low of 2.04% intra-quarter before recovering to 2.33%. Abroad, negative interest rate policy in Europe and the European Central Bank's continued quantitative easing have had the effect of driving European yields lower and pushing capital abroad. For the first time in the life of the Euro, debt issued by junk-rated European companies (BB-rated and lower) traded at the same yield level as U.S. Treasuries. The European Central Bank may begin tapering its asset purchases as early as December, which could potentially nudge U.S. interest rates higher and slightly widen credit spreads.

SUMMARY

The economy continues to expand at a modest rate of around 2.5% with inflation below the Federal Reserve's target of 2.0%. As a result, the multiple of earnings investors are willing to pay has risen this year in conjunction with rising corporate profits. This combination has resulted in a rising equity market in the U.S. Although the Federal Reserve continues down the path of "normalizing" monetary policy through the reduction of its $4.5 trillion balance sheet and two interest rate increases of 0.25% this year, financial conditions as measured by lower bond yields, tighter credit spreads, and a weaker U.S. dollar have combined to be a tailwind for domestic corporations.

The prospect of stimulating fiscal policy through a reduction in taxation has contributed to buoyant investor optimism, as well as the prospect for deregulation in certain industries. To the extent Congress is unable to deliver a reduction in tax rates, investor sentiment could turn more cautious which would have a negative spillover into the equity market. Regardless, there remains little near-term risk of a recession outside of an exogenous demand shock to the economy, such as a showdown with North Korea that is impossible to forecast.

*FINANCIAL MARKET TOTAL RETURN**

	Third Quarter 2017	**Nine Months Ending 09/30/17**	**One Year Ending 09/30/17**	**Annualized Return Two Years Ending 09/30/17**	**Annualized Return Three Years Ending 09/30/17**	**Annualized Return Five Years Ending 09/30/17**
Standard & Poor's 500 Index	4.48%	14.24%	18.61%	17.01%	10.81%	14.22%
Russell 2000 Index	5.67%	10.94%	20.74%	18.08%	12.18%	13.79%
Value Line Composite Index	3.69%	8.15%	13.73%	13.11%	6.23%	10.62%
Dow Jones Industrial Average	5.58%	15.45%	25.45%	20.35%	12.35%	13.57%
NASDAQ (OTC) Composite	6.07%	21.73%	23.79%	20.09%	14.52%	17.36%
Bloomberg Barclays Capital Gov't/Credit Intermediate Bond Index	0.60%	2.34%	0.23%	1.86%	2.13%	1.61%

* *Total Return Includes Income*

Michael C. Yeager, CFA
October 4, 2017

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