LUTHER KING CAPITAL MANAGEMENT

2017 REVIEW

A year ago investors were attempting to understand the implications of President-elect Donald Trump's agenda of tax reform, lighter regulation, and infrastructure spending to spur economic growth and create jobs. Initial investor optimism eroded in March as the failure to repeal and replace Obamacare, a Republican Congress' multi-year promise, cast doubt on the potential for the White House to accomplish other legislative agenda items, chiefly tax reform. Despite the legislative set back, three interest rate hikes by the Federal Reserve, and trade policy concerns, healthy corporate profit growth following two years of stagnation propelled the equity market to a record high in 2017. As the result of both higher earnings growth and expanded earnings multiples, the Standard & Poor's 500 Index rose 21.8% including dividends in 2017. The market advance was broad-based and persistent. Nine of the eleven equity market economic sectors recorded a positive return for the year, led by shares of technology stocks. In addition, the Standard & Poor's 500 Index rose during each month of the year – a first for the index. The strong equity market performance reflects the continued improvement of economic data, particularly related to manufacturing, housing, and jobs.

Despite significant strength in broad equity market indices, market internals were less impressive. First, the Standard & Poor's 500 Index, which is market-capitalization weighted, outperformed the Standard & Poor's 500 Equal Weight Index by 2.9%. This market characteristic is often associated with undistinguished market performance. Second, the performance of small capitalization stocks, as measured by the Russell 2000 Index, trailed the large capitalization based Standard & Poor's 500 Index by 7.2%. The 2017 equity market was also remarkable for its lack of daily volatility. As the following chart illustrates, there were only seven trading days in 2017 when the Standard & Poor's 500 Index changed by greater than 1% but less than 2%. Moreover, the last year in which the market recorded no daily moves greater than 2% was 2005.

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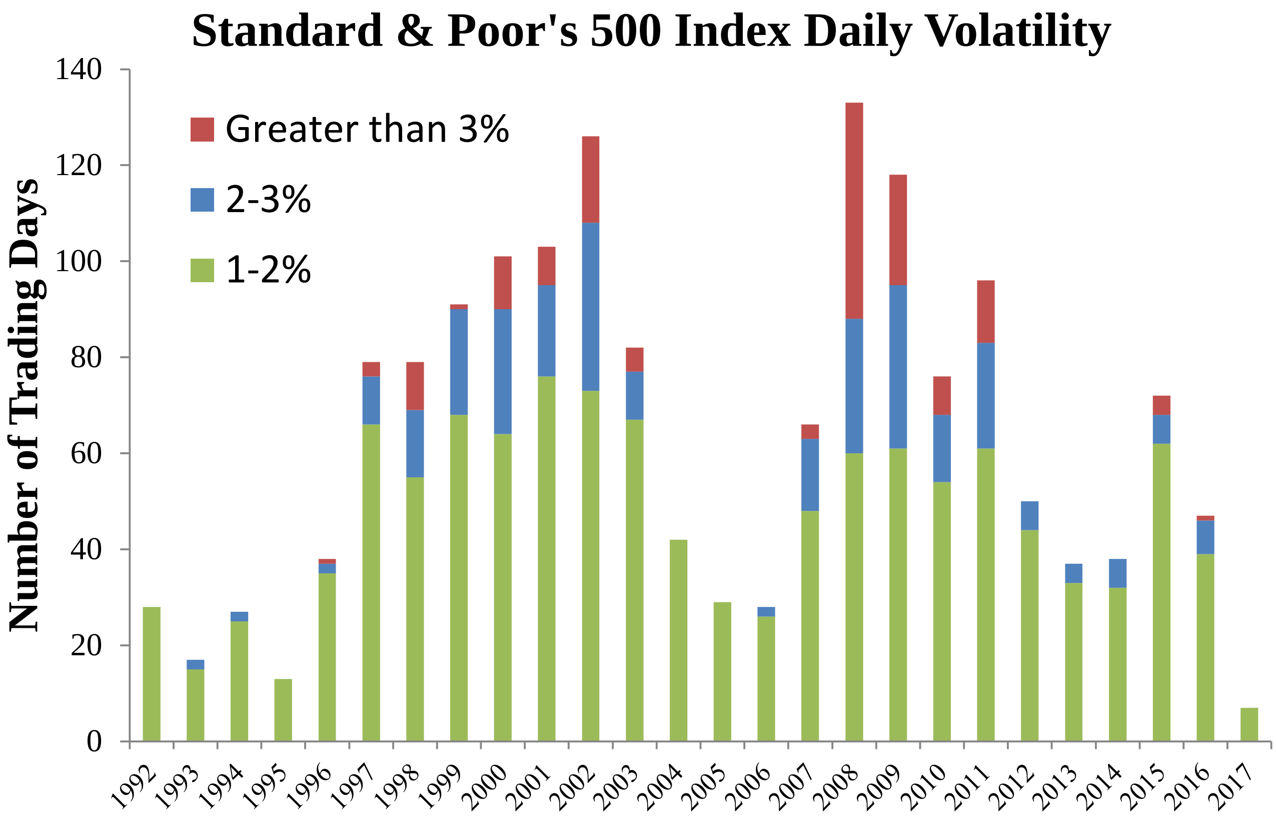


Source: Bloomberg

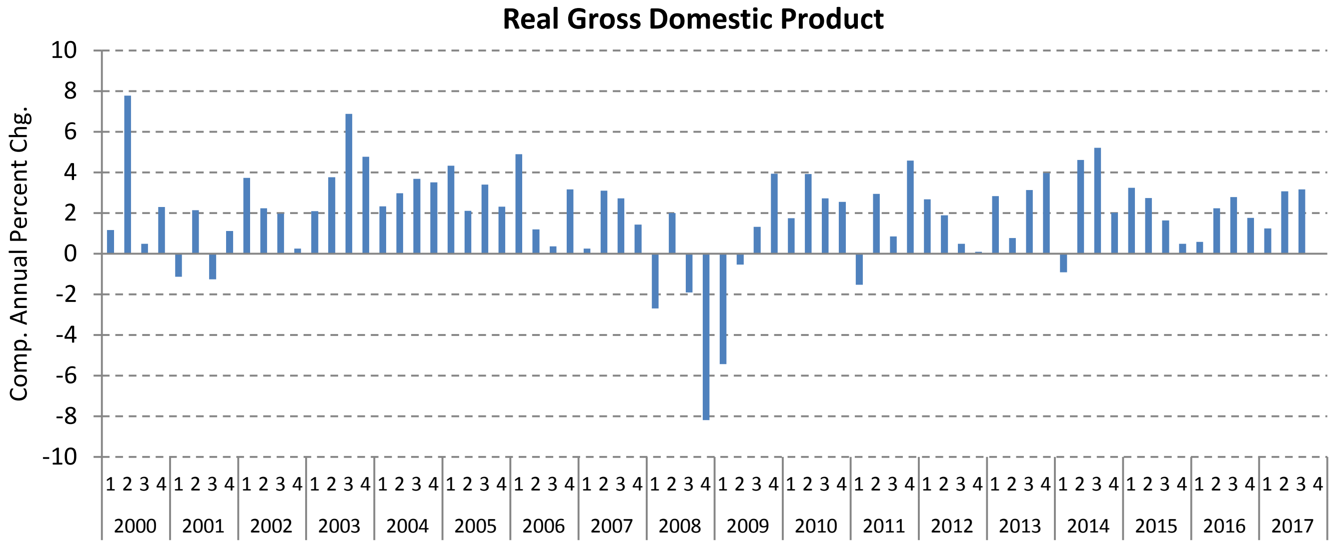
There is a great deal of debate among investors as to both the cause and the potential implications of extremely low equity market volatility. The mid-1990's displayed a similar profile of low daily volatility; however, it is generally agreed that financial markets are much more integrated today. This interconnectedness gives rise to concern that a ripple in one subset of financial markets can create a wave in another. The high-yield bond market, for example, continues to exhibit significant optimism with regard to historical loss rates. Any sudden widening of credit spreads in anticipation of higher losses could cause a disruption in equity prices. In addition, the rising presence of Exchange Traded Funds (ETFs) in the marketplace may be contributing to the lack of market volatility as the result of strong inflows, and a strong outflow could result in a market correction related to illiquidity in the underlying holdings of these instruments.

Turning to interest rates, after a roller-coaster year the yield on the 10-Year Treasury closed the year yielding 2.41%, a mere 0.04% less than where the yield began the year. The peak in yield on the 10-Year Treasury during 2017 of 2.63% occurred in March, two days prior to the third interest rate increase by the Federal Reserve for this tightening cycle. Jobs data was improving and investors began discounting the potential for rising inflation and further interest rate hikes by the Federal Reserve. The peak in bond yields coincided with investor concern regarding the White House agenda following the failure of Congress and the Administration to revamp health care regulation. In addition, geo-political tension with regard to Syria and North Korea was rising and the U.S. dollar continued to weaken. On the heels of the March 0.25% interest rate increase, the central bank raised rates an additional 0.25% in June and December. Partially in reaction to an increased pace of interest rate hikes, the short end of the yield curve rose dramatically. The yield on the 2-Year Treasury reached a nine-year high by late October and finished the year yielding 1.89%. The result was a dramatic flattening of the yield curve, or the difference in yield between the 2-Year Treasury and the 10-Year Treasury. A flattening of the yield curve has historically been viewed as a harbinger of slowing economic growth and rising recession risk. We believe that this traditional reading of a flattening yield curve is less applicable in today's environment where long yields are weighed down by ultra-low global bond yields, particularly in the Eurozone. Finally, due to the recent sharp rise in the 2-Year Treasury yield it is now competitive with the dividend yield on the Standard & Poor's 500 Index for the first time since 2008.

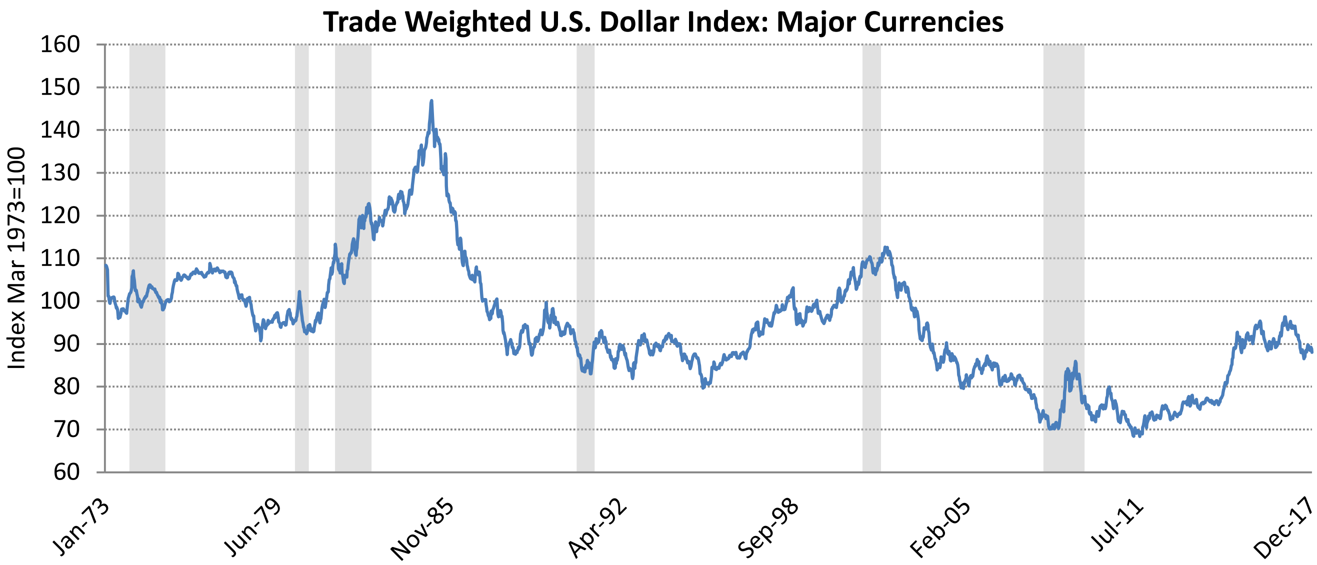
The current economic cycle is now thirty-five quarters in length, matching the duration of the 1960-1969 economic cycle, which makes it the second longest economic expansion since World War II. If the current expansion continues into the second half of 2019, it will become the longest expansion in the modern era, eclipsing the forty quarter expansion of the 1990's. A key factor in the longevity of the current economic expansion is its tepid pace of growth. During the current economic expansion, real Gross Domestic Product (GDP) has risen a modest 20% cumulatively compared to 52% in the 1960's expansion and 43% in the 1990's expansion. As a result of this slower growth, the lack of typical imbalances, such as overheated inflation, acute labor shortages, and excess capital investment, have allowed the Federal Reserve to take a more gradual path in raising interest rates.

In our view, the current expansion is likely to continue as fiscal stimulus in the form of lower tax rates and the probability of infrastructure spending propel economic growth into the second half of 2019. If the economy were to post two consecutive quarters of economic contraction, it would likely be the result of overly tight monetary policy or the ever possible exogenous shock to the economy caused by a geopolitical event. Such risks are low in our view, but the possibility remains. Much more likely would be the Federal Reserve accelerating its pace of interest rate hikes in response to rising inflation, as we discuss in our outlook for 2018.

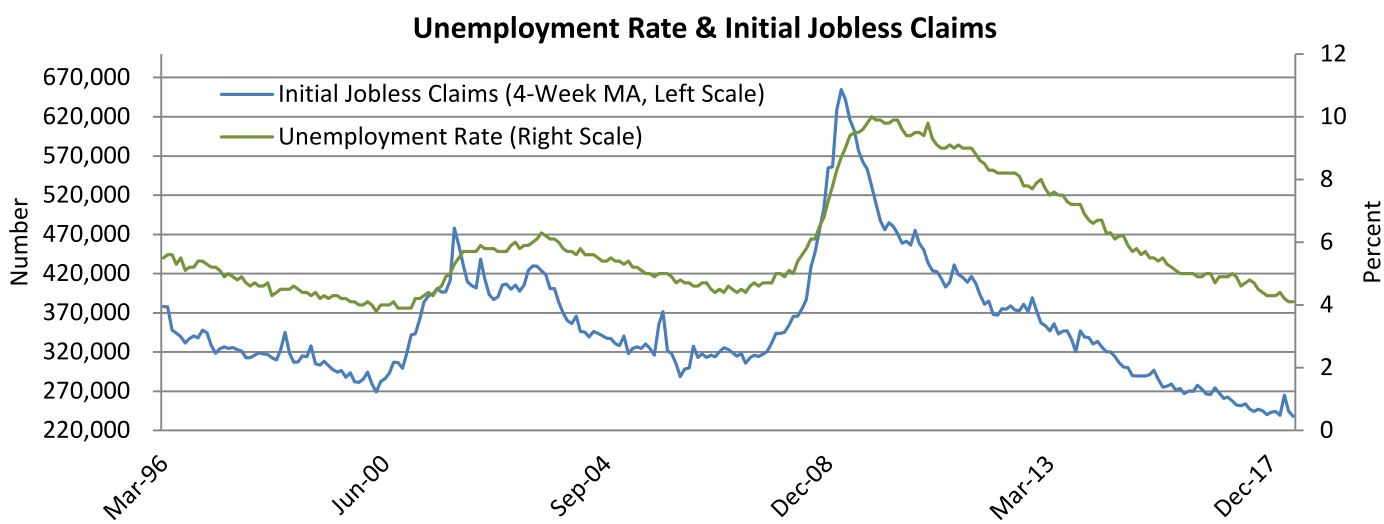
As we have in prior fourth quarter reviews, we have included a compendium of economic and market related charts.



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

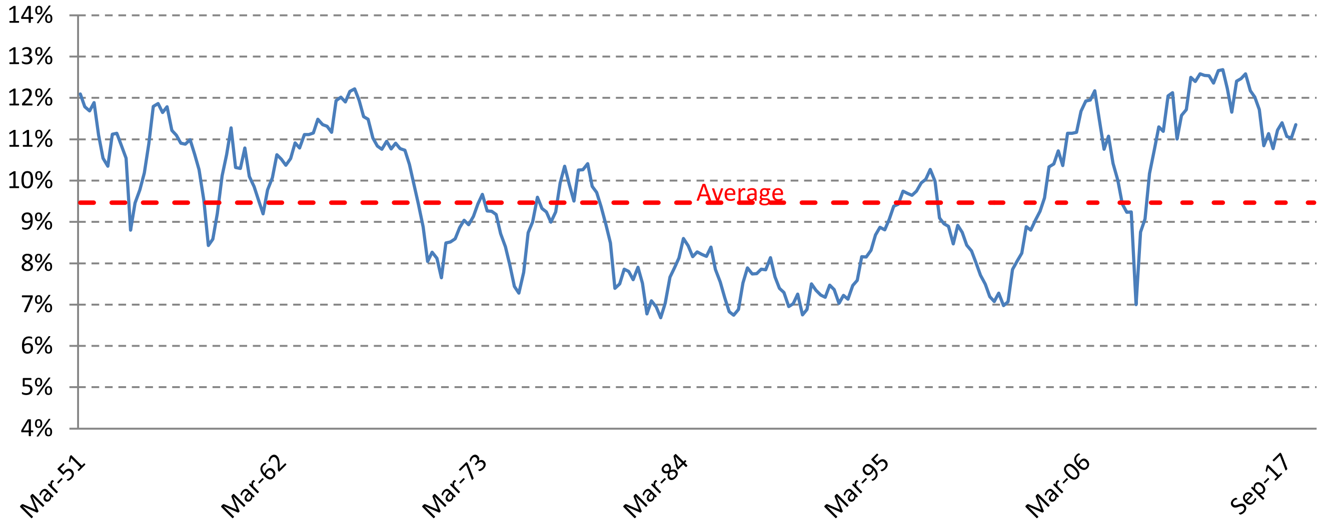


Source: Board of Governors of the Federal Reserve System



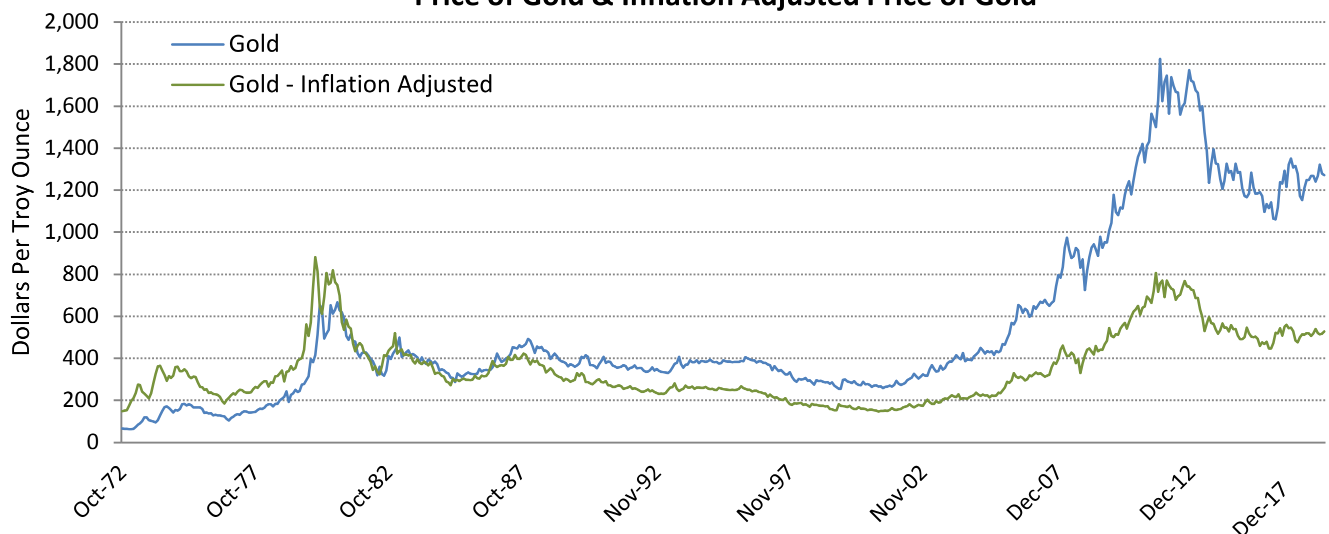
Source: U.S. Department of Labor: Employment and Training Administration/U.S. Department of Labor: Bureau of Labor Statistics

Corporate Profits as a Share of Gross Domestic Product



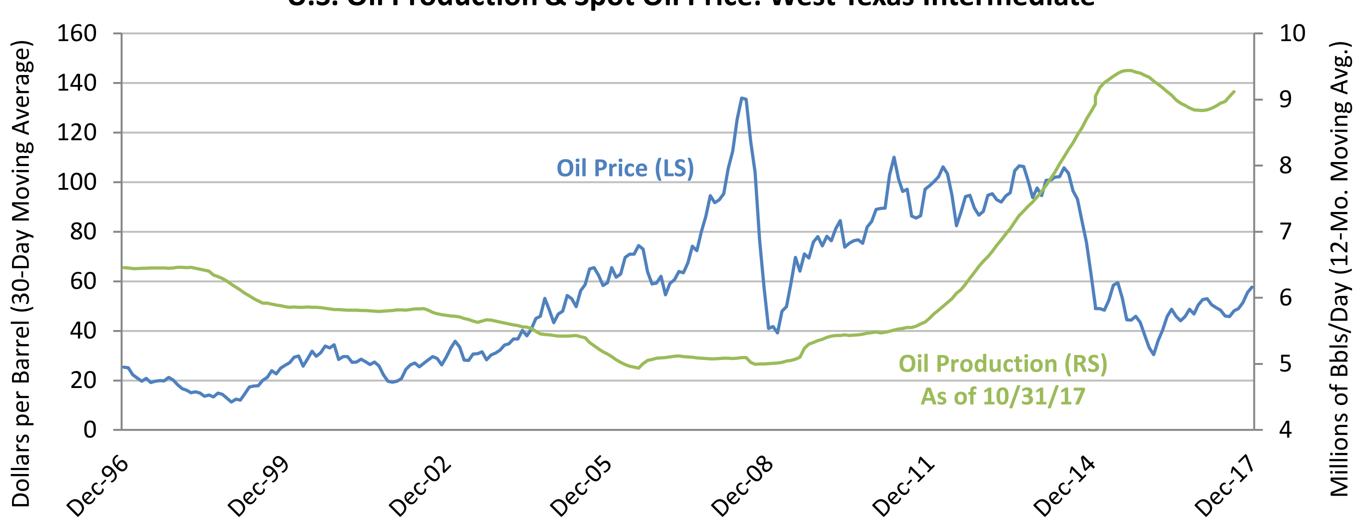
Source: U.S. Department of Commerce: Bureau of Economic Analysis

Price of Gold & Inflation Adjusted Price of Gold



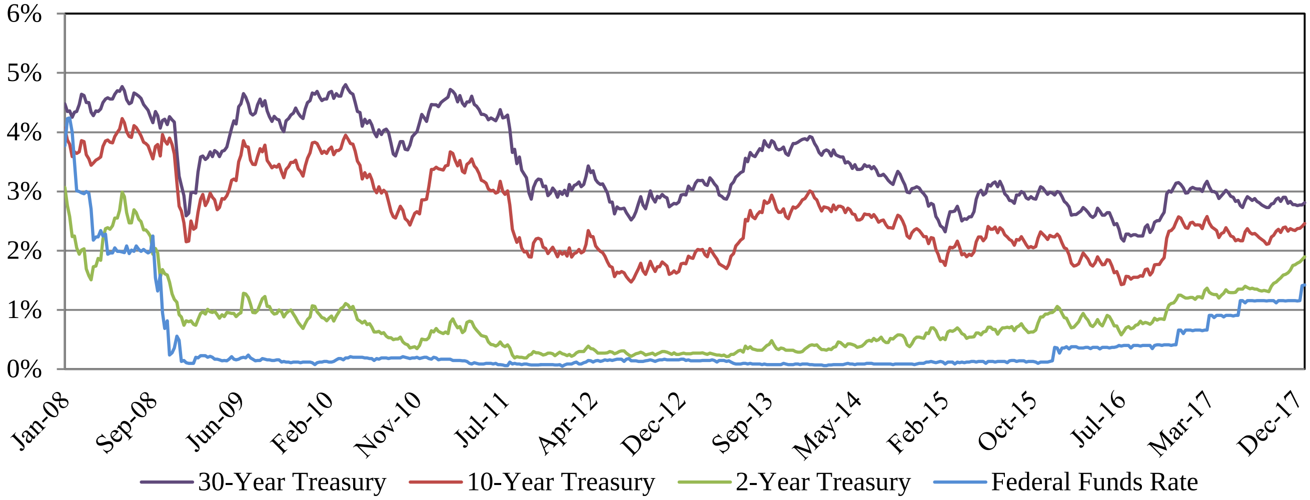
Source: Bloomberg, Inflation Adjusted Base 1984 = 100

U.S. Oil Production & Spot Oil Price: West Texas Intermediate



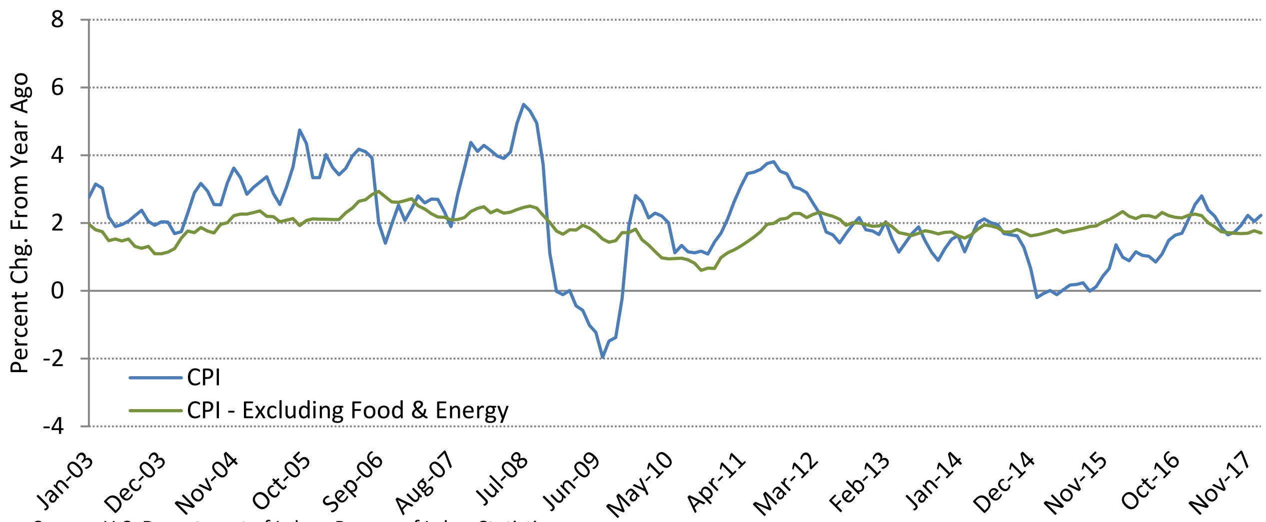
Source: Dow Jones & Company, Department of Energy

U.S. Treasury Rates & Federal Funds Rate



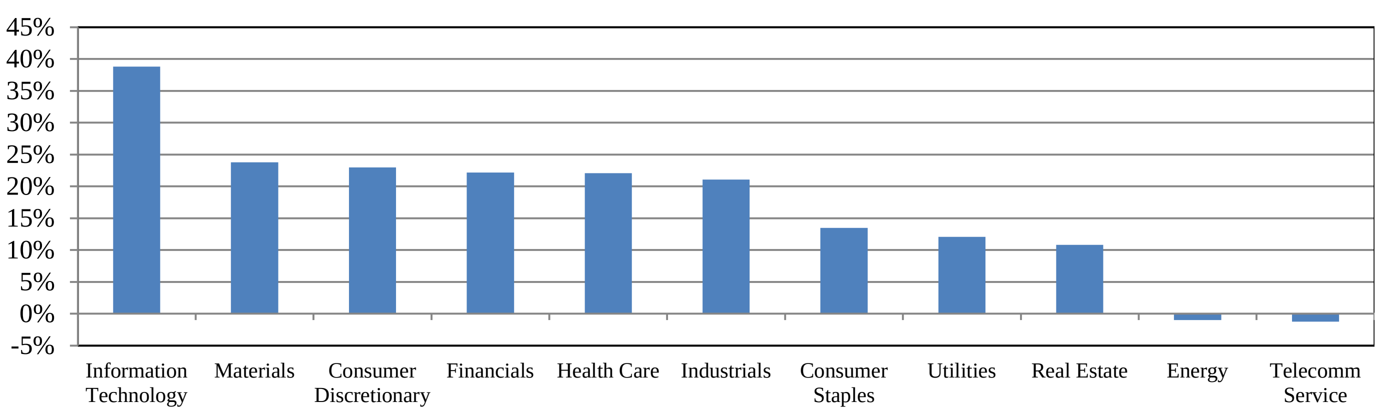
Source: Board of Governors of the Federal Reserve System

Consumer Price Index for All Urban Consumers: All Items
Consumer Price Index for All Urban Consumers: All Items Less Food & Energy



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

Standard & Poor's 500 Index
2017 Sector Performance (Total Return)



Source: Thomson Reuters Eikon

2018 OUTLOOK

The prior year ended with passage of the most sweeping tax reform legislation in over 30 years. The permanent reduction in the corporate tax rate to 21% from the highest 35% bracket has significant, though uneven, implications for corporations. As security analysts and portfolio managers, we are mindful of a corporation's effective tax rate, the amount corporations pay in taxes as a share of their pre-tax income. Historically, the effective tax rate could be materially less than the highest statutory tax rate of 35%. This paradox was especially true of multinational companies owing to the peculiar nature of our nation's approach to the taxation of foreign earnings of domestic companies.

Countries generally take one of two approaches to the taxation of corporate profits. One approach is the territorial system in which a country only taxes earnings that are generated within its borders. For example, given a Canadian company that has operations in the U.S., Canada would only assess corporate taxes on the earnings generated in Canada. The downside of this approach is that corporations are incented to generate earnings in lower tax rate jurisdictions abroad. Despite this shortfall, the territorial approach is the structure employed by most developed nations. The second approach to corporate taxation is the worldwide corporate tax system. Under this framework, countries tax all corporate earnings regardless of their country of origin. This system has the benefit of eliminating the weakness of the territorial system, which encourages corporations to "move" earnings off-shore. A key drawback to worldwide corporate tax systems is that it can encourage corporations to relocate their headquarters to lower tax jurisdictions, a process often referred to as a corporate inversion.

Prior to the just completed tax overhaul, the U.S. operated a modified version of the worldwide corporate tax system in which global corporate profits where taxed, but not until they were brought back to the U.S., known as repatriation. The new tax legislation adopts a territorial system, largely exempting foreign earnings from taxation, but with several complex provisions meant to prevent the abuses encouraged by the territorial system. Under the new legislation, all untaxed earnings currently held off-shore will be deemed to have been repatriated. However, the applicable tax rate on repatriated earnings varies. For liquid assets such as stock, bonds, and cash, the tax rate is 15.5%. For profits held in hard assets such as real estate and equipment, the applicable tax rate is 8%.

It is estimated that between $1.5 trillion and $2.5 trillion of foreign earnings of U.S. corporations remain off-shore. With these profits now deemed to have been repatriated, corporations have the ability to return that capital to the U.S. to be invested in property, plant and equipment, acquisitions, or returned to shareholders through dividends and share repurchases. A growing list of companies including Southwest Airlines, American Airlines, and Comerica have chosen to inaugurate the change in the corporate tax rate by providing a one-time cash bonus to employees. The U.S. attempted a repatriation holiday in 2004 which gave corporations the option to bring foreign profits back to the U.S. subject to a 5.25% tax rate. The 2004 exercise was not terribly effective or efficient due to the fine print, which included restricting the use of the repatriated capital. We are optimistic that the freeing of foreign capital held by U.S. multinational corporations will boost corporate spending and provide the potential for higher returns of capital to shareholders.

For corporations whose "effective tax rate" was the same as the statuary rate, their after-tax earnings will rise by over 20%, all else being equal. We estimate that Standard & Poor's 500 Index earnings for 2018 will rise 15% - 18% year-over-year. Roughly half of this increase is attributable to the lower corporate tax rate. The extent to which lower corporate taxes bolster economic growth will depend on the behavior of corporations. Historically, reductions in corporate taxes have led to an increase in capital expenditures. A lack of capital investment is one of the reasons for the tepid rate of the current economic expansion. The extent to which companies make further investments will determine the degree to which the reduction in corporate taxes has a compounding effect for future growth or is simply a one-time change in corporate earnings. To further encourage capital spending, the new tax legislation allows for the 100% expensing of capital expenditures for tax purposes, an increase from 50% for the next five years. We believe this is an important measure and has the potential to increase productivity which has been waning for many years.

The reduction in the corporate tax rate is a clear near-term tailwind for corporate earnings and upgrades our outlook for the equity market in 2018. It would be unusual for the equity market to decline during a year in which we anticipate corporate profits to rise at a mid-teen growth rate. While optimistic about economic growth and the equity market, the timing of the tax cuts paradoxically increases the risk of shortening the current business cycle. In the past, Congress has used tax cuts to revive economic growth following recessions. The recent tax cut, in contrast, arrives in year nine of economic growth and amidst clear signs of strengthening manufacturing, better housing data, tightening labor conditions, rising energy prices, and a falling U.S. dollar. Real economic growth should accelerate from the 2% level recorded in recent years to closer to 3%. Such a move could ignite inflationary pressures thereby prompting the Federal Reserve to quicken its pace of interest rate hikes and bring about the familiar close of a business cycle through an overtightening of monetary policy. Inflationary readings will be key data to monitor in 2018 for signs the Federal Reserve may accelerate monetary tightening.

We anticipate that GDP growth will accelerate in 2018 driven in part by higher personal consumption, which represents almost 70% of GDP. Most workers will see an increase in their payroll check by February 15th when employers will be required to use updated payroll withholding tables issued by the U.S. Treasury Department. This incremental consumer income is arriving at a time when the personal savings rate of 2.9% of personal disposable income is near a decade low level. Americans were saving an average of 6.0% of personal disposable income as recently as the fourth quarter of 2015. With real GDP growth potentially rising to 3.0% for 2018 and corporate profits anticipated to grow between 15% and 18% year-over-year, the economy is set to receive a near-term dose of fiscal stimulus. It would be unusual for equity prices to perform poorly against this economic backdrop although we would not be surprised if the market retraced 5% to 10%, or greater, at some point within the next year as the market is historically overdue for a correction.

*FINANCIAL MARKET TOTAL RETURN**

	Fourth Quarter 2017	**Six Months Ending 12/31/17**	**One Year Ending 12/31/17**	**Annualized Return Two Years Ending 12/31/17**	**Annualized Return Three Years Ending 12/31/17**	**Annualized Return Five Years Ending 12/31/17**
Standard & Poor's 500 Index	6.64%	11.42%	21.83%	16.79%	11.41%	15.79%
Russell 2000 Index	3.34%	9.20%	14.65%	17.93%	9.96%	14.12%
Value Line Composite Index	4.78%	8.64%	13.31%	14.56%	5.93%	11.04%
Dow Jones Industrial Average	10.96%	17.16%	28.11%	22.16%	14.36%	16.37%
NASDAQ (OTC) Composite	6.57%	13.04%	29.73%	18.90%	14.83%	19.50%
Bloomberg Barclays Capital Gov't/Credit Intermediate Bond Index	(0.20%)	0.40%	2.14%	2.11%	1.76%	1.50%

* *Total Return Includes Income*

Michael C. Yeager, CFA
January 6, 2018

IMPORTANT INFORMATION

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