LUTHER KING CAPITAL MANAGEMENT

FIRST QUARTER 2018 REVIEW

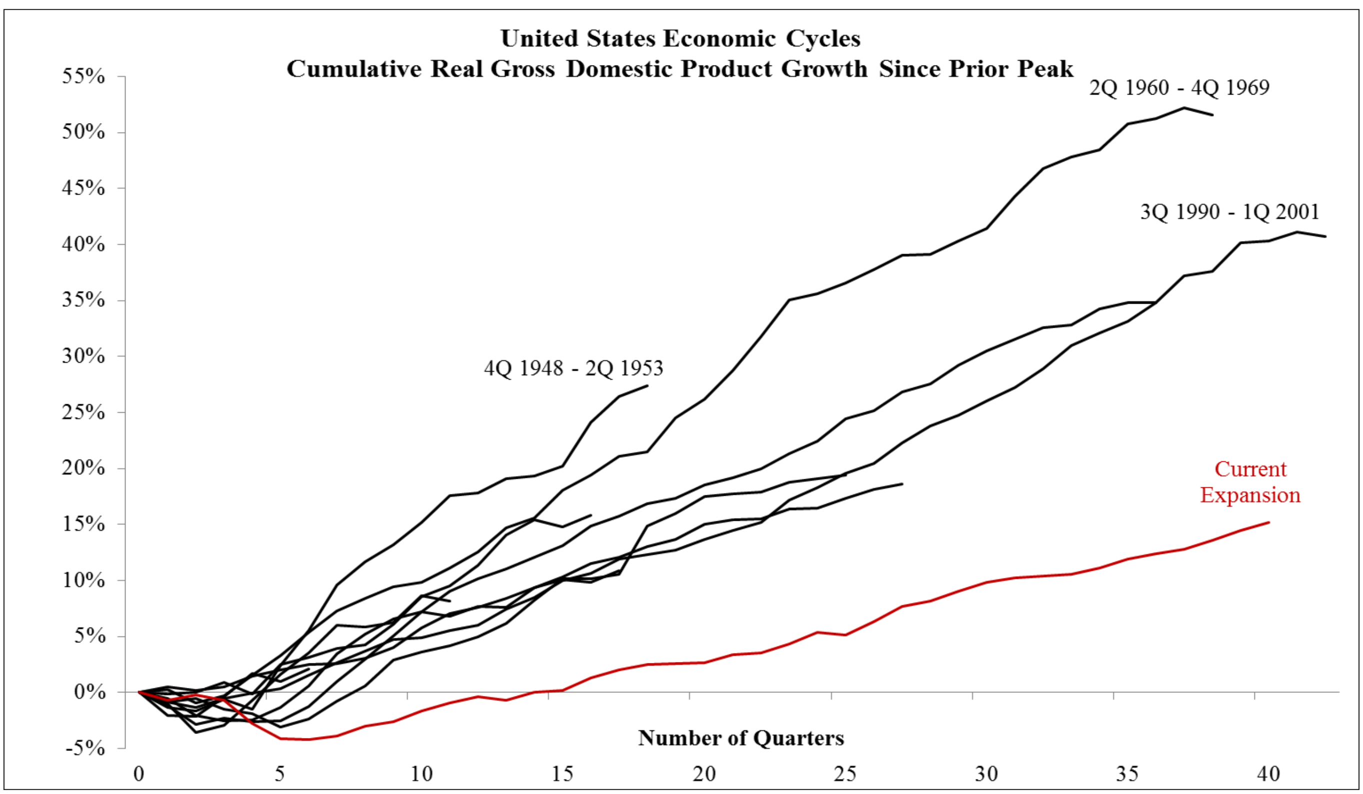
What the current economic cycle lacks in robustness it has made up for in longevity. Muted economic growth and an absence of meaningful inflationary pressure have given the Federal Reserve ample runway to slowly lift interest rates. In March the Fed raised its key short-term interest rate 0.25% for the sixth time this cycle. As monetary policy continues to tighten, current fiscal policy provides an expansionary offset to promote further economic growth. The result should be faster economic growth in 2018, as compared to prior years. However, as economic growth accelerates, greater attention will be paid to inflationary pressures as the key barometer for the pace of monetary tightening.

The return of equity market volatility during the quarter was a stark departure from the historically low volatility witnessed in 2017. Fear of stronger inflation precipitated the initial market decline in early February which was exaggerated by many investors being positioned for continued low market volatility. Capital markets were also caught off guard by the Administration's clamorous rhetoric on tariffs and the potential of a trade war. While we remain vigilant of the risk of a broad trade war, the Administration's pattern of saber rattling as an opening gambit from which to launch negotiations is now a familiar pattern.

For the quarter, the equity market as measured by the Standard & Poor's 500 Index declined 0.76%, including dividends. Corporate earnings are a coincident indicator of corporate health and will improve markedly in 2018 aided by the Tax Cuts and Jobs Act of 2017. We estimate corporate earnings will eclipse $150 per share for the Standard & Poor's 500 Index this year, suggesting at least 15% growth year-over-year, with approximately one half of the earnings growth the result of lower corporate tax rates. The multiple that investors are willing to pay for each dollar of earnings, known as the price/earnings ratio, is anticipatory in nature. Investors intuitively weigh the sum of their future expectations for areas such as economic growth, corporate earnings, inflation, interest rates, and global risk. In the first quarter, the earnings multiple that investors were willing to pay declined and offset the growth in corporate earnings.

ECONOMY

The current economic cycle is now forty-one quarters old and is one quarter shy of the longest cycle in post-war history which ended in the first quarter of 2001. Historically, economic cycles are most often brought to a close by the tightening of monetary policy in response to rising inflationary pressures. After the onset of the financial crises, the Federal Reserve reduced its target interest rate from 3.00% to a range of 0.00% to 0.25% in 2008 in an attempt to revive growth. Sluggish domestic and global growth and a dearth of inflationary pressures allowed the central bank to maintain interest rates near zero for a protracted period, making this economic cycle unique. In fact, there were occasional concerns that price levels might actually fall. Meanwhile, the unemployment rate reached 10.0% in December of 2009, the second highest level in post-war history. The ultra-accommodative monetary policy became the best response to promote the Federal Reserve's dual mandate of price stability and full employment. While the unique character of the Great Recession may well contribute to the longest post-war economic expansion, it has also created the weakest recovery. As the chart below illustrates, the current economic expansion has generated a mere 15.2% cumulative growth in real Gross Domestic Product (GDP) compared to an average of 23.0% for the other ten economic cycles since World War II.



Source: National Bureau of Economic Research, Bureau of Economic Analysis, Strategas, LKCM

Weak investment in capital, such as plant, property, and equipment, has been one result of tepid economic growth this cycle. Firms have had little impetus to expand capacity or upgrade methods of production. In our view, this dynamic is set to change for the following reasons.

Real economic growth accelerated to 2.3% in 2017, and we forecast it will accelerate again in 2018, although, when reported, the first quarter of 2018 will likely display weather related weakness. Better economic growth should boost confidence in corporate boardrooms to make additional capital investments. One proxy for business confidence, the Small Business Optimism Index, recorded its highest reading since 1983 in February.

Second, a meaningful component of the Tax Cuts and Jobs Act of 2017 is the ability for businesses to expense 100% of certain capital purchases in calculating taxable income, a process known as “bonus depreciation.” Previously, purchases of certain new capital equipment were subject to 50% first-year bonus depreciation. This provision of the Act, however, begins to sunset in five years and is fully eliminated in 2027. Therefore, firms only have a limited window to act on this provision.

The third reason that we are optimistic about 2018 capital expenditures is that the age of the American capital stock, such as buildings, roads, and machinery, continues to rise. The average age of all fixed assets was 22.8 years in 2016 and is moving higher as governments and companies have been dilatory in replacing or expanding current fixed assets. The average age of domestic factories is very near the historic high since the U.S. Bureau of Economic Analysis began collecting data in 1925. Although spending on capital equipment could add to inflationary pressures, much of the recent focus has been centered on wage inflation. Moreover, a strong capital expenditure cycle should lead to better worker productivity thereby alleviating the cost of higher wages.

In the 1950’s the economist William Phillips observed that unemployment and inflation are inversely related. Yet, the falling unemployment rate in recent years has thus far been unable to create persistently high wage growth. In fact, the current unemployment rate of 4.1% will likely fall further this year. Explanations for the lack of wage inflation generally fall into one of three categories. The first explanation is that the methodology used by the U.S. Bureau of Labor to calculate the unemployment rate does not properly capture the true nature of the employment market due to issues such as labor force participation. Second, labor has become a global resource and international labor markets undermine domestic wage growth. Finally, the role of automation in the production of goods continues to grow providing a substitute to labor for increasing output. Our base case continues to be benign wage growth of around 2.5% annually, which is similar to the past two years, as the labor force participation rate continues to rise.

Opposing the multiple cited economic tailwinds is the rising threat of protectionism. The potential for trade wars has come into sharp focus over the past several weeks following the imposition of tariffs on steel and aluminum imports. It is quite challenging to parse the potential impact to the economy if the government moves forward with further trade restrictions, which appears likely at the moment. In one sense tariffs act as a tax on consumers. Ostensibly, tariffs protect domestic suppliers from lower-cost imports, while also defending American workers. Domestic aluminum and steel producers will likely raise prices as competition from imports eases. To the extent companies have the pricing power to pass along the higher aluminum and steel input prices to consumers, consumers are effectively being taxed.

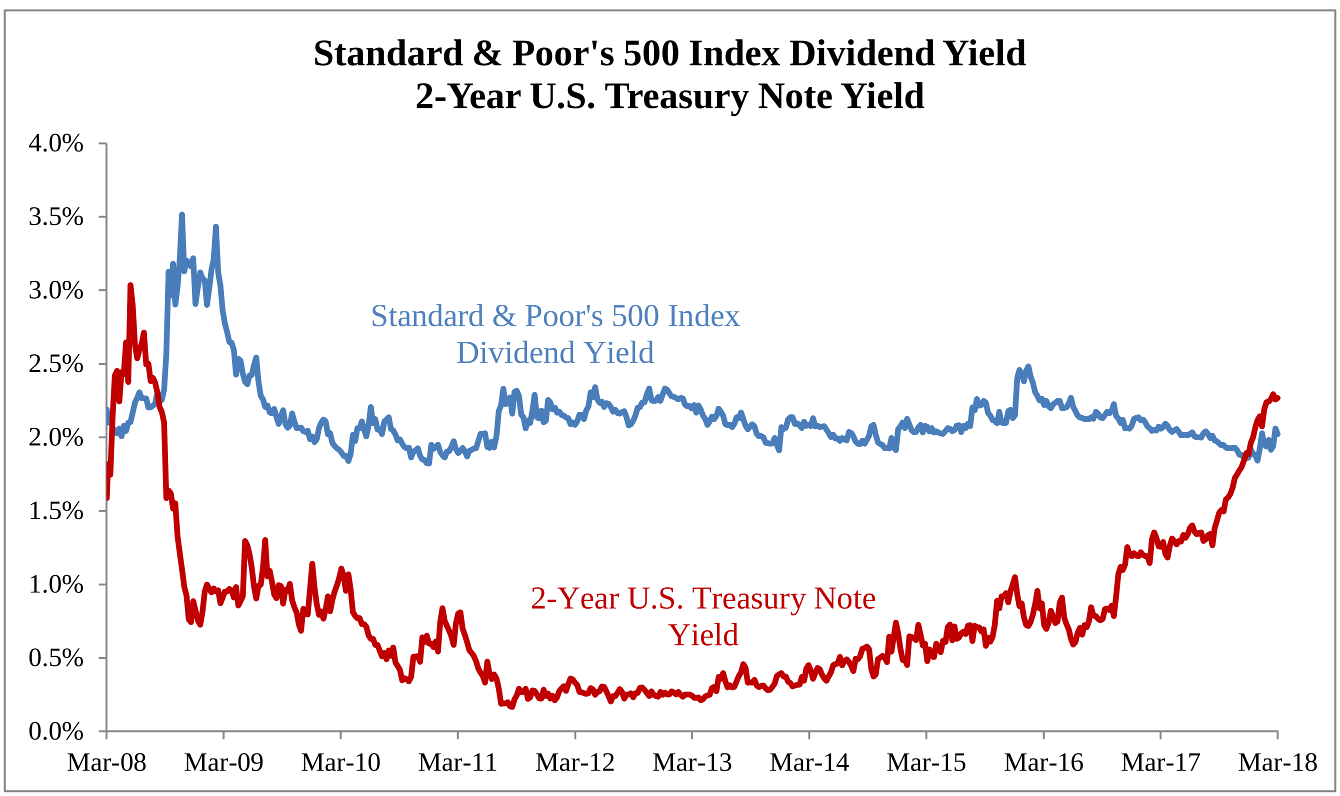
Our expectation is that there will be a moderate amount of protectionism put in place which will be industry specific and is likely to have little influence over global economic growth. Countries which fare worse in a trade war are those that are very open to trade, do not have the capacity to increase domestic demand, and produce products that are more easily substituted. By these measures, the U.S. has a relative advantage. However, we view the risk as being skewed to the downside with a spark for a larger trade war already in place with the U.S. investigation of Chinese intellectual property practices, often referred to as a section 301 investigation. The outcome of the current investigation should be revealed within the next few months. As with most "wars", the degree of escalation and the symmetry of responses will be key determinants in the ultimate outcome.

CAPITAL MARKETS

Historically normal levels of equity market volatility resumed in the first quarter. While the equity market was buffeted by headlines of trade wars and inflation, we remain focused on the health of corporate profits. Passage of the Tax Cuts and Jobs Act of 2017 insures strong corporate profits growth for the coming year. There have been several periods in which corporate earnings have grown at the rate as we forecast for 2018. In each case, as today, the yield on the 10-Year Treasury was rising, manufacturing activity was expanding, the U.S. dollar was falling and crude oil prices were increasing. Although the equity market can move counter to earnings growth in the short-run, in the medium to long-term equity prices mirror the arc of corporate earnings.

The Federal Reserve first raised its target interest rate during this cycle in December of 2015 following seven years of a Federal Funds target range of 0.00% - 0.25%. Lack of meaningful inflation and a slow healing labor market resulted in just one interest rate increase by the central bank in 2016. However, following three interest rate increases last year and another three interest rate increases expected for 2018, investors must begin incorporating higher interest rates into their outlook.

Higher interest rates have several implications for investors. First, interest rates factor into the multiple investors are willing to pay for corporate earnings. The value of future corporate earnings falls as interest rates rise. Consequently, investors are only willing to pay a lower price/earnings multiple for those future earnings. Second, higher interest rates make fixed income more attractive relative to equities. For much of the past decade, the dividend yield of stocks well exceeded the income earned by owning short-term government bonds. This dynamic is shifting as the chart below illustrates. For the first time since the third quarter of 2008, the yield on the 2-Year Treasury note is higher than the dividend yield of the Standard & Poor's 500 Index. Given our forecast for further interest rates hikes we continue to favor short duration bonds. Finally, higher interest rates place incremental stress on government, corporate and household borrowers. Higher interest rates require resources to be siphoned from spending or saving to service debt.



Source: Bloomberg, LKCM

CONCLUSION

The Standard & Poor's 500 Index's run of nine consecutive quarters of gains came to a close in the first quarter. However, our outlook remains constructive for the year as the impact from the recent expansionary fiscal policy remains in front of us. Investors will remain sensitive to signs of rising inflation and vigilant of the Federal Reserve's interest rate forecast. In our view, there will be sufficiently upward pressure on inflation to cause the Federal Reserve to further increase interest rates by at least 0.50% through year-end.

Countries such as China and Japan each own slightly more than $1 trillion of U.S. Treasury debt. One view is that these holdings are a byproduct of an attempt by both countries to cheapen their currencies and therefore boost exports. As a result, the U.S. experiences a meaningful and persistent trade deficit. Part of the Administration's framework appears to be the assumption that, in a world of free trade and floating exchange rates, sustained trade imbalances can only be the result of unfair trade practices through either state assistance to subsidize output or foreign exchange intervention intended to prevent currencies from being a natural scale in the trade equation. A repeat of the Smoot-Hawley Tariff framework from the 1930's remains remote because of the U.S reliance on foreign purchasers of our national debt, namely China. In addition, Congress has the ability to regulate commerce despite the legislative branch granting Trade Promotion Authority to the executive branch under President Obama. Congress could begin to reassert its authority over commerce.

We remain optimistic about the equity market for the balance of the year and continue to be cautious of the bond market given our forecast of rising interest rates for the year. Economic growth in Europe is slowing at the margin and is part of what global equity markets digested in the first quarter. If protectionism is indeed mostly sound and fury, then the equity market should quickly discount any trade tariffs that are erected, and investor focus should again return to the health of corporate profits.

*FINANCIAL MARKET TOTAL RETURN**

	First Quarter 2018	Six Months Ending 03/31/18	One Year Ending 03/31/18	Annualized Return Two Years Ending 03/31/18	Annualized Return Three Years Ending 03/31/18	Annualized Return Five Years Ending 03/31/18
Standard & Poor's 500 Index	(0.76%)	5.84%	13.99%	15.57%	10.78%	13.31%
Russell 2000 Index	(0.08%)	3.25%	11.79%	18.79%	8.39%	11.47%
Value Line Composite Index	(2.29%)	2.38%	7.18%	12.03%	4.29%	8.13%
Dow Jones Industrial Average	(1.96%)	8.78%	19.39%	19.65%	13.48%	13.32%
NASDAQ (OTC) Composite	2.59%	9.34%	20.85%	21.91%	14.35%	18.13%
Bloomberg Barclays Capital Gov't/Credit Intermediate Bond Index	(0.98%)	(1.18%)	0.35%	0.39%	0.94%	1.25%

** Total Return Includes Income*

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April 5, 2018

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