LUTHER KING CAPITAL MANAGEMENT

SECOND QUARTER 2018 REVIEW

For much of the past year "synchronized global growth" has been an apt description of the global economy. With an economic growth tailwind, central bankers in the U.S., Europe, and Japan have been keen to withdraw overly-accommodative monetary policy in anticipation of the next economic downturn. More recently, however, economic growth outside the U.S. has begun to decelerate, making the reduction of easy money more of a risk for global growth. The ability of global economic growth to resynchronize is made more uncertain by the presence of rising protectionism related to trade. For the moment, the U.S. is increasingly the primary engine of global economic growth. Following 2.0% growth in real Gross Domestic Product (GDP) in the first quarter, the domestic economy is likely to have expanded by more than 3.5% when the second quarter GDP reading is released.

Increasingly, investor focus shifted to emerging market economies, which had benefited significantly from broad global growth. In recent years, these markets have revived global trade, manufacturing, and commodity prices. Despite more restrictive monetary policy, particularly in the U.S., the value of the U.S. dollar fell last year, aiding emerging market debt denominated in U.S. dollars. Recently, however, the positive backdrop for emerging markets has deteriorated with a rising U.S. dollar, slowing global growth, and greater protectionism.

Domestically, the economy has yet to feel the full impact of fiscal stimulus. The sustainability of a fiscally-induced economic expansion largely will depend on the prospect for productivity-increasing investments, which would lift the economy's growth potential. As we have highlighted previously, there are specific provisions of the tax legislation which target accelerated investment by companies. Our outlook for productivity-enhancing capital expenditures remains positive, as it is increasingly important to sustained economic growth. Late cycle stimulative fiscal policy in the form of lower tax rates supports above-trend economic growth, but this stimulus occurs at a time when the economy's excess capacity has shrunk considerably. This combination could well result in inflationary wage pressure and rising input costs for firms.

ECONOMY

The rate of economic growth in the U.S. rose during the second quarter in contrast to the softening of the other remaining ten largest global economies. A similar slowing of global economic growth occurred in 2015 and caused the Federal Reserve to slow its intended pace of monetary tightening. In contrast, the Federal Reserve is unlikely to abandon its current plans which call for two additional interest rate increases of 0.25% each later this year. The economic output gap, or the difference between economic output and potential economic output, has narrowed over the past two years. As a result, the U.S. economy no longer has spare capacity. When taken in tandem with a 48-year low in the unemployment rate of 3.75% in May, it is unlikely in our view that the Federal Reserve will slow its pace of monetary tightening. As a result, the risk of a monetary policy error, or over-tightening in a slowing economy, has risen. This risk is particularly true if economic growth outside the U.S. continues to slow or there is a further escalation of tariffs.

The degree to which the U.S. should be concerned over its existing trade deficit has quickly become a central economic question. One line of reasoning is that the current trade deficit, which is the result of importing more goods than our country exports, has led to less domestic manufacturing and therefore fewer manufacturing jobs. The Trump administration has elected to erect new tariffs or raise the level of existing tariffs in an effort to level the playing field and protect domestic manufacturing. The inherent challenge is that countries impacted by newly enacted U.S. tariffs are naturally inclined to react in kind by altering their trade policies. This process is made more complex by the fact that it is difficult to calibrate the impact of trade tariffs, and the economic impact is not linear. This concept is highlighted by the complex web known as the global manufacturing supply chain. China, for example, assembles a great number of goods comprised of components imported from other countries, such as memory chips and digital displays. If Chinese imports were to experience a 10% decline, Taiwan, Malaysia, and South Korea would suffer a markedly larger blow to their domestic economies relative to China.

The administration's protectionist rhetoric appears to have a three-pronged purpose. First, it was evident early in his presidential campaign that President Trump intended to defend U.S. manufacturing. Second, the administration appears to view the North American Free Trade Agreement (NAFTA) as less favorable to the U.S. than to Mexico or Canada. Finally, it is apparent there are increasing concerns over the theft of U.S. corporate intellectual property. In our view, the pursuit of trade protectionism on a larger scale would eventually trim domestic economic growth and create detrimental knock-on effects such as lowering business confidence at a time the economy needs further productivity-enhancing capital investment.

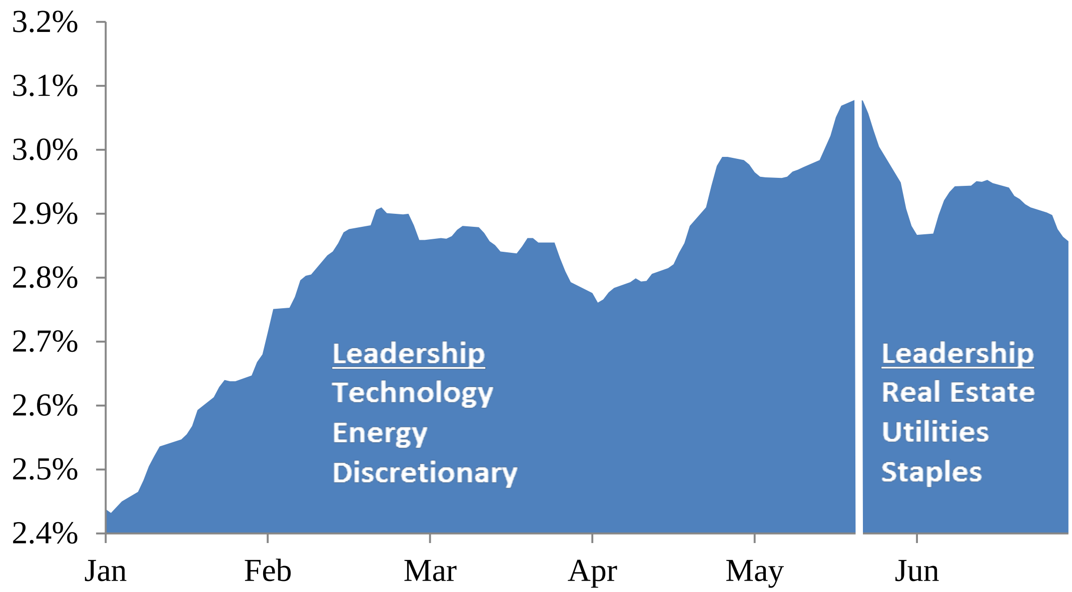
CAPITAL MARKETS

The combination of corporate and personal tax reductions, lighter regulation, and the repatriation of overseas cash held by U.S. corporations has helped set the stage for faster economic growth in 2018 compared with the prior year. As a result, we forecast corporate earnings growth will eclipse 20% for the year, with approximately half of the growth resulting from lower corporate taxes. The strong wave of corporate earnings growth has been met by lower Price/Earnings ratios, or valuations, which has resulted in the Standard & Poor's 500 Index advancing a modest 2.6% during the first half of 2018.

The equity market's earnings multiple reflects a combination of expected future growth as well as other variables, chiefly interest rates. The year began with ebullient economic and corporate earnings growth expectations against a relatively low interest rate backdrop by historical standards. The result was a forward Price/Earnings multiple of 18.7X for the Standard & Poor's 500 Index at the beginning of the year. Through the first half of the year, the Price/Earnings ratio has compressed two full turns to 16.7X as of the end of June. Earnings multiples are coincident indicators that vacillate with changes in investors' perception of the real economy. Troubling trade headlines, rising interest rates, and a declining outlook for growth negatively weighed on investors' perception through the first half of the year. Statistically, there is a near-zero correlation between a given market Price/Earnings ratio and the equity market return over the subsequent twelve months. However, there is a statistically significant relation between a given market Price/Earnings ratio and the prospective ten-year equity market return. Therefore, an optimistic view of the compressed earnings multiple during the first half of 2018 is that it raises the equity market's future potential level of return over the longer term.

With regard to the fixed income market, interest rates rose during the first half of the year, resulting in a decline in bond prices. The yield on the 10-Year Treasury rose from 2.41% at the beginning of the year to a high of 3.11% in May before closing the second quarter with a yield of 2.86%. The level of interest rates, and more importantly what those rates imply about the U.S. economy, often has a direct impact on equity market leadership. As the chart below illustrates, while interest rates were rising into May, cyclical components of the equity market performed best. Once interest rates peaked, market leadership rotated to sectors which benefit more from lower interest rates.

U.S 10-Year Treasury Yield &
Standard & Poor's 500 Index Sector Leadership



Note: Treasury yield is a 5-day moving average

Source: Bloomberg, Citigroup, LKCM

In our view, there are two possible paths which lead to interest rates finishing the year higher than their current levels. The first scenario would be driven by an acceleration of economic growth, fueled by an uptick in productivity due to higher business capital expenditures. Investors would discount an increase in economic growth and would favor equities over fixed income, resulting in higher bond yields and lower bond prices. The alternative scenario is less attractive. Under this framework, economic growth slows to a more pedestrian pace but inflation accelerates, driven by rising protectionism, higher deficits, and little economic slack. Either scenario could result in the yield on the 10-Year Treasury rising convincingly above 3.0% for a sustained period. If rates rise because productivity and potential economic output increase, this would further elongate the economic expansion. If, however, rates were to increase under a stagflation scenario, the risk of a policy error on the part of the Federal Reserve rises. Our base case is for the first scenario and is supported by stronger capital expenditures in the first quarter compared to the fourth quarter of last year. In addition, credit spreads remain near cyclical lows, which suggest investors are more positive on the corporate outlook.

Outside of the U.S., the combination of rising U.S. interest rates and a stronger U.S. dollar creates peril within emerging markets. Nearly 80% of emerging market foreign currency debt is denominated in U.S. dollars. As emerging currencies depreciate relative to the U.S. dollar, central bankers in those economies often raise interest rates to defend their currencies. The result is often a dramatic slowing of their economic growth, which makes the repayment of their U.S. dollar-denominated debt more difficult. A familiar economic response to a rising wave of debt obligations in emerging markets is to simply inflate their way out of debt. While we do not currently see an emerging market crisis similar to 1998, emerging markets disruption bears watching.

CONCLUSION

The U.S. economy remains on its gradual progression through a typical business cycle, albeit longer than average, as the underpinnings remain solid. However, late-cycle dynamics such as tighter labor markets have begun to push wages higher, allowing the Federal Reserve to remain on the path to tighter monetary policy. The effect is a traditional flattening of the yield curve over the past year. Meanwhile, other late-cycle warning flags, such as deteriorating credit conditions reflected by widening credit spreads are not yet evident. Similarly, pressure from rising wages to date is not compressing corporate profit margins, which is typical of a mature business cycle. The later stages of the business cycle are usually reflected in the equity market by a narrowing of market leadership, with investors bidding growth stocks higher in pursuit of continued growth as the broad economy begins to cool.

*FINANCIAL MARKET TOTAL RETURN**

	Second Quarter 2018	Six Months Ending 06/30/18	One Year Ending 06/30/18	Annualized Return Two Years Ending 06/30/18	Annualized Return Three Years Ending 06/30/18	Annualized Return Five Years Ending 06/30/18
Standard & Poor's 500 Index	3.43%	2.65%	14.37%	16.12%	11.93%	13.42%
Russell 2000 Index	7.75%	7.66%	17.57%	21.03%	10.96%	12.46%
Value Line Composite Index	4.71%	2.32%	11.16%	13.64%	6.50%	8.45%
Dow Jones Industrial Average	1.26%	(0.73%)	16.31%	19.18%	14.07%	12.96%
NASDAQ (OTC) Composite	6.61%	9.38%	23.64%	26.04%	16.04%	18.61%
Bloomberg Barclays Capital Gov't/Credit Intermediate Bond Index	0.01%	(0.97%)	(0.58%)	(0.40%)	1.16%	1.60%

* *Total Return Includes Income*

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