

# LUTHER KING CAPITAL MANAGEMENT

## *THIRD QUARTER 2018 REVIEW*

The major economic development this year in the U.S. has been the acceleration of economic growth, fueled partly by the December 2017 tax legislation which led to a boost in business and consumer confidence. The domestic economy grew at a real annual rate of 4.2% in the second quarter, with stronger personal consumption and higher federal government spending primarily responsible for the accelerating growth. The strength of the economy is also evident in strong corporate revenue growth, which we estimate will be between 8.5% and 9.0% for the Standard & Poor's 500 Index this year. Corporate earnings per share will increase more than twice this rate of revenue growth, reflecting positive operating leverage, fewer shares outstanding, but primarily lower corporate tax rates. Equity prices reflected the strength of the economy and higher corporate profits by returning 7.7% during the third quarter as measured by the Standard & Poor's 500 Index.

The simmering trade war has remained below the boiling point after recent progress was achieved with Mexico and Canada, although trade with China will likely remain the administration's focal point. While improvements related to tariffs are generally viewed as leveling the playing field, it may not necessarily result in a narrower trade deficit. Current expansionary fiscal policy boosts aggregate demand, including demand for imports. In addition, the recent strength of the U.S. dollar makes imports more attractive to consumers relative to domestic goods, which further exacerbates the trade deficit.

Emerging market economies are subject to episodic bouts of sharp contraction due to varying degrees of reliance on narrow industrial bases, U.S. denominated sovereign debt, and slim foreign currency reserves. Governments of emerging economies have a large demand for foreign capital to support domestic infrastructure spending. Foreign investors have increasingly demanded that sovereign bonds of emerging market nations be denominated U.S. dollars, thereby reducing the temptation for indebted nations to inflate their way out of debt by simply printing additional local currency.

In recent years paltry global interest rates, and in some cases negative interest rates, have spurred investors starved for yield to seek relatively high yielding emerging market sovereign debt. This has created several unique opportunities for nations, such as Argentina which was able to float 100-year U.S. dollar denominated debt last year. Today an increasing number of emerging markets are being buffeted by the rising U.S. dollar, higher commodity prices, and capital flight. For example, the Argentine peso has declined 55% year-to-date against the U.S. dollar with short-term interest rates roughly doubling to 42.3% in the country. As a result, the Argentine stock market return through the first three quarters of the year in U.S. dollars terms declined 50%. Unlike 1997-1998, however, our view is that the emerging market issues remain contained and will have only limited influence on our domestic economy.

## ***ECONOMY***

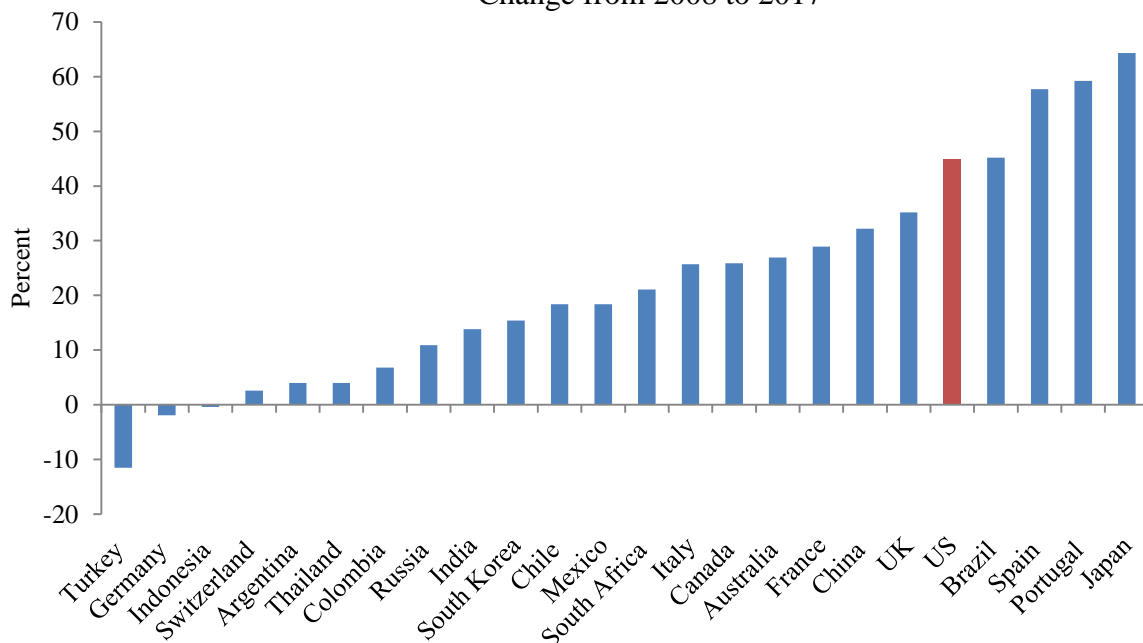
The acceleration of the U.S. economy this year is evident across a broad spectrum of economic gauges. As reflected in the Purchasing Managers' Index (PMI), domestic manufacturing recorded its twenty-fifth consecutive month of expansion. Manufacturing strength continues despite rising input costs, a tight labor market, tariff uncertainties, capacity limitations, and higher transport cost. The non-manufacturing sector of the economy also demonstrated improved strength in the third quarter. The ISM Non-Manufacturing Index registered its highest reading since the inception of the data series twenty-one years ago. Positive job creation has occurred for ninety-six consecutive months. As a result, U.S. economic growth is materially higher than other large developed economies.

Central bank monetary policy mirrors the divergence of economic growth in developed economies. The Federal Reserve has increased its target interest rate by a quarter percent in each of the first three quarters this year. The European Central Bank, in contrast, is unlikely to begin raising interest rates before the fall of next year. Domestically, expansionary fiscal policy in the form of lower tax rates and higher deficit spending helps to drive above trend economic growth, which allows the Federal Reserve to gradually tighten monetary policy. This hand-off between expansionary fiscal policy and tighter monetary policy has thus far been relatively smooth. A primary benefit of this process is the Federal Reserve's ability to essentially reset monetary policy in the form of higher interest rates. This reset will enable the Federal Reserve to better maneuver monetary policy to combat the next economic downturn when it occurs.

The dynamic interplay between fiscal and monetary policy can be seen in various consumer-related data. Wage increases are beginning to be achieved as evidenced by the August reading of 2.9% annual growth, registering the highest level since the recession ended in 2009. This data series tends to correlate well with the Job Openings and Labor Turnover Survey (JOLTS) data which suggests that wage growth is likely to continue to strengthen. Insight into whether consumers are likely to spend or save their incremental wages can be found in a review of the savings rate. Currently, the personal savings rate is 6.6% of disposable income, down from 7.4% in February of this year; implying consumers have recently been inclined to spend higher wages. The bolstering of wages due to a tightening labor market and lower tax withholding schedules has enabled consumers to absorb higher mortgage rates, which have increased 38% from the cycle low 3.4% to 4.7% currently for a 30-year fixed rate mortgage.

While lower personal and corporate tax rates have received the greatest degree of attention, federal deficit spending has also been a key driver of fiscal stimulus. As the chart below illustrates, federal spending as a percent of Gross Domestic Product (GDP) has risen by 45% from 2008 to 2017. As we have discussed in prior Reviews, it is uncommon for the government to pursue such stimulative fiscal policy in the latter stages of a business cycle. The result is a growing federal budget deficit which will climb towards \$1 trillion for the current fiscal year, nearly a 20% increase over the prior fiscal year. While we do not currently view the federal deficit to be particularly worrisome at the moment, it will likely receive a great deal of attention in the next downturn.

Government Debt As A Percent of GDP  
Change from 2008 to 2017



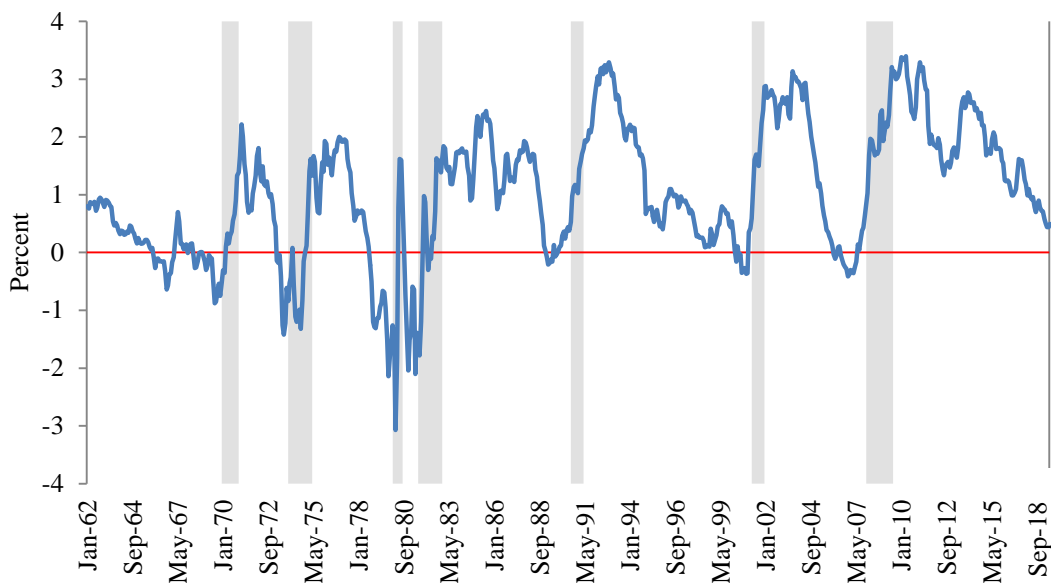
Sources: Bloomberg, LKCM

## CAPITAL MARKETS

It is becoming commonplace among investors to forecast the onset of the next bear market. This prognosticating is a natural outgrowth of the observation that the current business cycle is long in the tooth. Next year the current business cycle is likely to eclipse the March 1991-March 2001 period to become the longest growth cycle since the 1850's when data keeping was initiated. Bear markets are associated historically with economic recession, but not always. There have been bear markets, defined by a 20% or greater decline in a broad market index, associated with a monetary policy mistake (1976), a financial crisis (2008), and excessive speculation (1987).

While it is our view that the next bear market is likely to be accompanied by a recession, the good news is that we have yet to see a rise in the typical harbingers of a downturn. Recessions are commonly preceded by an inverted yield curve, accelerating wage inflation, deteriorating credit conditions, subpar Purchasing Manager Index data, a spike in energy prices, and rising unemployment. Much has been written of the flattening yield curve, which is a narrowing of the yield on long-dated bonds compared with short-dated bonds. A negative sloping shape of the yield curve has historically portended a recession. Below is a chart showing the difference between the ten-year and one-year Treasury yield, dating to 1962.

U.S. Treasury Yield Curve  
1-Year to 10-Year  
(Recession Periods Noted in Gray)



Every recession during this period of time was preceded by short-term rates rising above long-term rates, often referred to as an inversion of the yield curve. The inversion of the yield curve over this period produced only one false positive which was in the mid-1960's when the economy slowed but did not enter into a recession. The applicability of this framework has endured through various economic backdrops. The Federal Reserve, often in an attempt to rein in inflation, raises short-term interest rates. At the same time, yield on long-dated bonds, which captures investors' long-term prospects for the economy, begins to fall as investors' optimism dims. A flatter yield curve makes it more challenging for banks to profit as banks typically "borrow short and lend long." Lower bank profitability can negatively impact banks' willingness to lend and therefore reduce credit availability for the economy. While the yield curve has clearly flattened, it has yet to invert.

A second key recession indicator is the widening of credit spreads in the fixed income market. This spread captures the difference between what corporations must pay in the bond market in excess of the yield on a comparable Treasury security. If investors perceive deteriorating economic conditions, they will demand higher compensation to lend their capital in the form of higher interest rates. A widening of credit spreads is therefore indicative of fear that economic trouble lies ahead. Credit spreads are often correlated with volatility in the equity market. Both credit spreads and equity volatility remain near cycle lows. While some indicators on our recession dashboard have weakened slightly, in the aggregate they still point to a robust economy and market. As a result, we remain constructive on the economy, and we place the odds of a recession within the following twelve months as relatively low.

Finally, the mid-term elections are near and the probable scenario of a Democratic House and Republican Senate are likely discounted by the capital markets. Historically, a split Congress has been positive for equity markets as investors perceive gridlock preferable to the possibility of one political party's agenda being unchecked. It is interesting to note that the Standard & Poor's 500 Index has recorded a higher level twelve months following each mid-term election beginning with the 1946 election. One posit is that the president's party typically loses seats in mid-term elections, and therefore the president becomes more pro-growth in the final two years of his administration in hopes of securing victory in the following presidential election. As pro-growth initiatives are announced following mid-term elections, the equity market embraces the favorable impact of this stimulation and climbs higher.

## *CONCLUSION*

The strong performance of the equity market year-to-date reflects the underlying strength of the economy. The Federal Reserve has, thus far, been successful in tightening monetary policy while creating no material drag on economic growth. In essence, the Federal Reserve is attempting to orchestrate a “soft landing” which would equate to raising short-term interest rates to a neutral level. The challenge is knowing the precise level of the neutral, or equilibrium, interest rate. The Federal Reserve successfully achieved a soft landing in the mid-1990’s tightening cycle. However, historically the Federal Reserve has lifted short-term interest rates above the neutral rate, precipitating a recession. In our view, such a monetary policy error remains one of the primary risks to the economy.

Fiscal stimulus has propelled the economy and corporate earnings forward this year and there is additional fiscal stimulus in the pipeline for next year in the form of lower personal tax payments in April. With continued fiscal stimulus, the Federal Reserve is likely to continue to tighten monetary policy. In fact, we anticipate the Federal Reserve will tighten an additional quarter percent in December of this year. In addition to balancing tighter monetary policy, investors must contend with continuing trade discussions and their implications, emerging market turmoil, and modestly rising inflation. Moreover, another looming concern is higher oil prices, which, at present levels, are taking a portion of the individual’s tax cut through higher gasoline prices and act as a brake on the long-lived expansion.

## ***FINANCIAL MARKET TOTAL RETURN\****

	<b>Third Quarter 2018</b>	<b>Nine Months Ending 09/30/18</b>	<b>One Year Ending 09/30/18</b>	<b>Annualized Return Two Years Ending 09/30/18</b>	<b>Annualized Return Three Years Ending 09/30/18</b>	<b>Annualized Return Five Years Ending 09/30/18</b>
Standard & Poor's 500 Index	7.71%	10.56%	17.91%	18.26%	17.31%	13.95%
Russell 2000 Index	3.58%	11.51%	15.24%	17.96%	17.12%	11.07%
Value Line Composite Index	2.83%	5.21%	10.24%	11.97%	12.14%	7.32%
Dow Jones Industrial Average	9.63%	8.83%	20.76%	23.09%	20.49%	14.57%
NASDAQ (OTC) Composite	7.42%	17.49%	25.22%	24.57%	21.81%	17.83%
Bloomberg Barclays Capital Gov't/Credit Intermediate Bond Index	0.21%	(0.76%)	(0.96%)	(0.37%)	0.91%	1.52%

*\* Total Return Includes Income*

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October 8, 2018

## **IMPORTANT INFORMATION**

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