

LUTHER KING CAPITAL MANAGEMENT

2018 REVIEW

The Standard & Poor's 500 Index declined 4.4% in 2018, marking the first negative total return year since 2008. The string of nine consecutive years of positive returns tied the 1991 – 1999 period as the longest streak of positive returns since 1936. During 2018 the Standard & Poor's 500 Index experienced two market corrections, defined as a decline greater than 10%. The first market correction occurred during the first quarter. The equity market rose sharply in January as investor optimism for stronger corporate profit growth, aided by newly lowered corporate tax rates, boosted stock prices. However, this enthusiasm was undermined in early February over concern that accelerating wages would compel the Federal Reserve to hasten the pace of monetary tightening and increase the probability of a recession. As a result, the Standard & Poor's 500 Index recorded its first market correction in almost two years.

The equity market then rallied in the second quarter as weak first quarter consumption reversed with retail sales growing 6% year-over-year in May and the unemployment rate falling to 3.8%, its lowest reading since 1969. During the third quarter, the equity market continued to rally, posting a 7.7% gain in the Standard & Poor's 500 Index, which included the index peak for the year on September 20th. The market declined 18.9% from this peak through the low on Christmas Eve, with 57% of the constituents of the Standard & Poor's 500 Index down more than 20% from their 52-week highs. Despite negative returns from domestic equity indices, both developed and emerging international equity markets indices reported even weaker returns, especially in U.S. dollar terms as the U.S. dollar strengthened against most currencies in 2018.

A key risk to the economy in the short run had been a monetary policy error by the Federal Reserve – specifically, the risk of the Federal Reserve continuing its current pace of four interest rate hikes per year even as economic growth begins to slow. Monetary policy acts with a lag of between three and eight calendar quarters, therefore the interest rate hikes in March, June, September, and the recent December one of 2018 are still in the process of flowing through the economy in terms of higher lending rates for mortgages, autos, and businesses. In an October 3rd interview, Federal Reserve

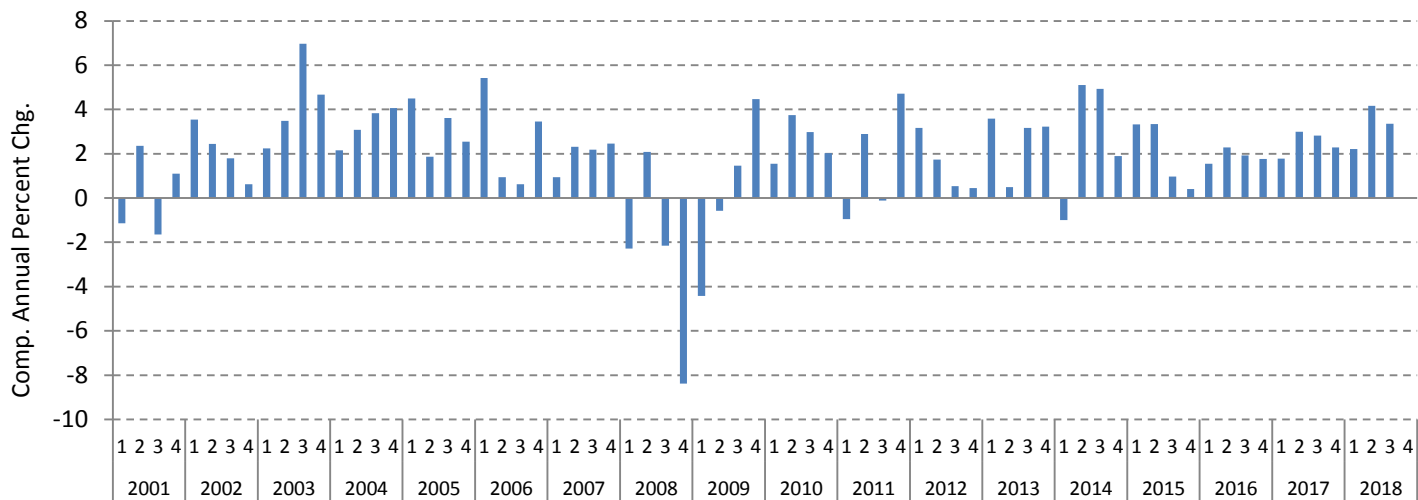
Chairman Powell stated, “Interest rates are still accommodative, but we’re gradually moving to a place where they will be neutral.” He added, “We may go past neutral, but we’re a long way from neutral at this point, probably.” This statement by Chairman Powell was widely interpreted by the capital markets as an indication that not only was the Federal Reserve committed to its current pace of monetary tightening, but we were likely well short of the terminal Federal Funds rate for this monetary tightening cycle, which significantly contributed to the fourth quarter equity market decline.

A persistent theme of 2018 was the flattening of the yield curve, or the narrowing of the rate of interest the government pays on short-term versus long-term debt obligations. The flattening has been the result of the Federal Reserve raising interest rates on the short end, while rates at the long end decline. Long-term rates generally reflect investors’ expectation for long-term economic growth. Therefore, lower rates at the long end of the curve are emblematic of softening investor optimism for future growth. The yield differential between the 1-year Treasury bill and the 10-year Treasury note shrunk to 0.08% by the end of 2018 from 0.66% at the beginning of year. With the yield curve nearly flat, it is difficult to gauge whether or not it will invert. This inversion will depend in part on whether the Federal Reserve pursues multiple interest rate hikes this year. There has been quite a bit of deliberation over whether the Federal Reserve would intentionally invert the yield curve by raising short-term rates. There are two important considerations with regard to the yield curve. First, although the yield curve has historically been a reliable indicator of recessions, it does not necessarily cause a recession. For example, the curve inverted in the mid-1960’s without a follow-on recession because the Federal Reserve quickly reversed its course. Second, a yield curve inversion does not suggest a recession is on the immediate horizon. The indicator has led the past nine recessions between six and twenty-four months. It is natural for the yield curve to flatten late in an economic cycle; however, other recessionary gauges show little signs of near-term recession probability.

The decline in the equity market during the last month of 2018 was similar to the drawdown in early 2016 when concerns about a weakening Chinese economy roiled global markets. At the time, the domestic economy was teetering on the brink of a recession, which prompted the Fed to postpone rate hikes. In contrast, the Federal Reserve increased its target Federal Funds interest rate a fourth time in 2018 just as concerns of slowing economic growth - both at home and abroad - began to intensify. As a result, December 2018 was a historically difficult month for the Standard & Poor’s 500 Index, which declined 9.0%, its worst December performance since 1931.

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

Real Gross Domestic Product



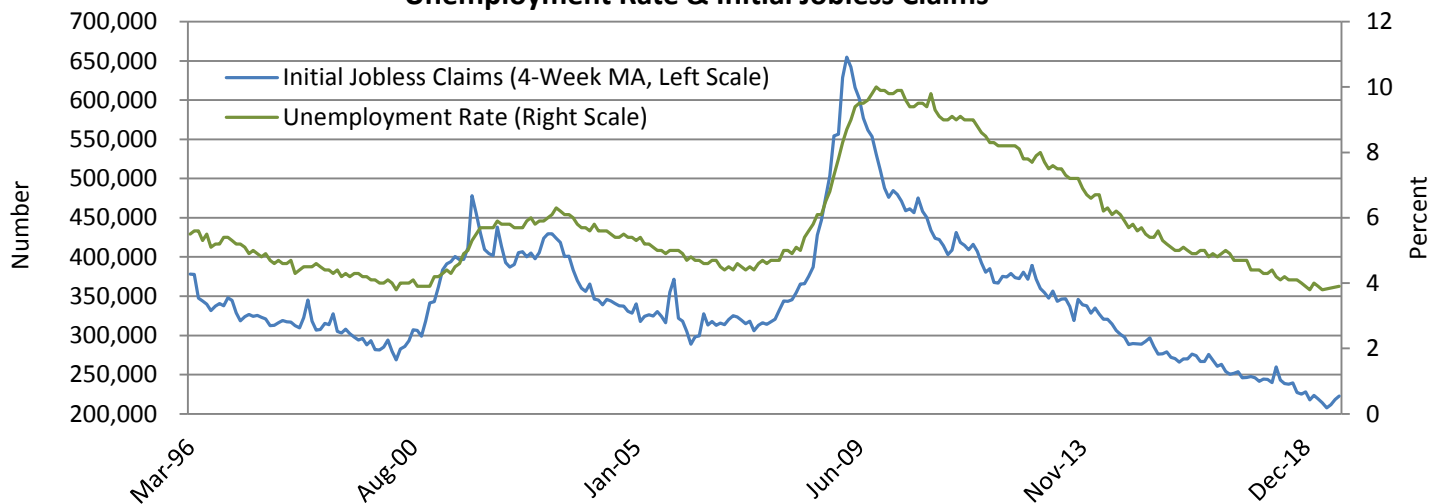
Source: U.S. Department of Commerce: Bureau of Economic Analysis

Trade Weighted U.S. Dollar Index: Major Currencies



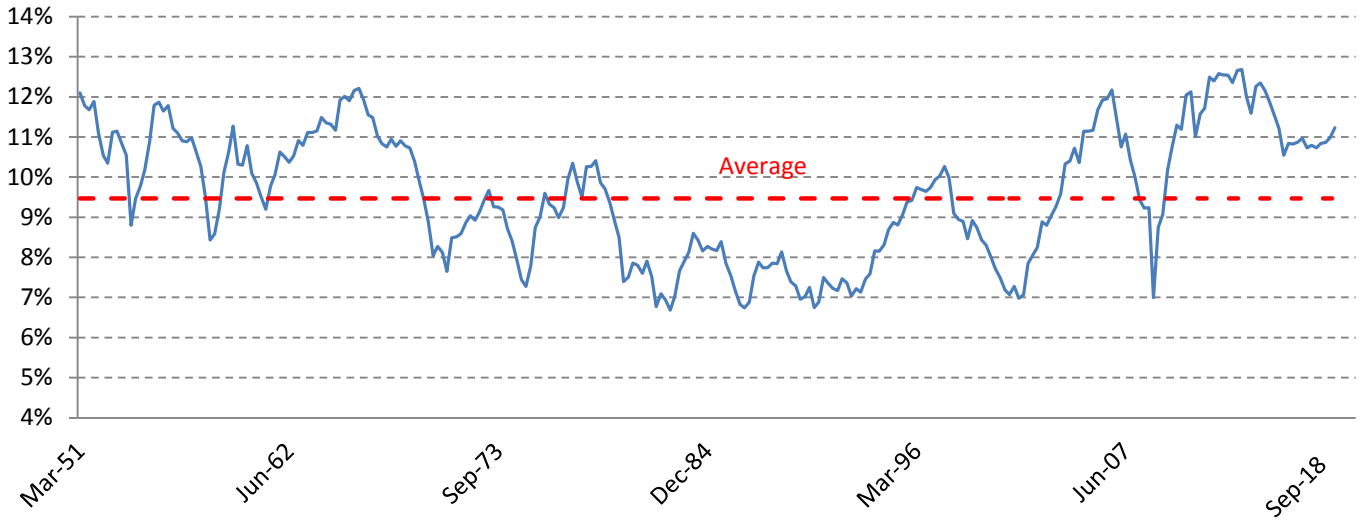
Source: Board of Governors of the Federal Reserve System

Unemployment Rate & Initial Jobless Claims



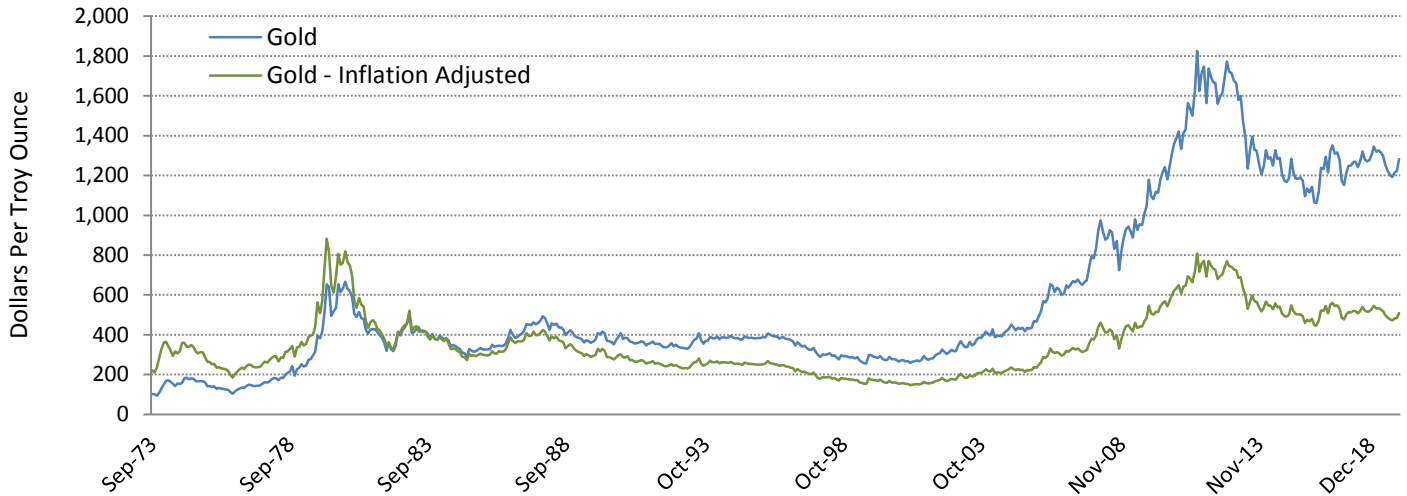
Source: U.S. Department of Labor: Employment and Training Administration/U.S. Department of Labor: Bureau of Labor Statistics

Corporate Profits as a Share of Gross Domestic Product



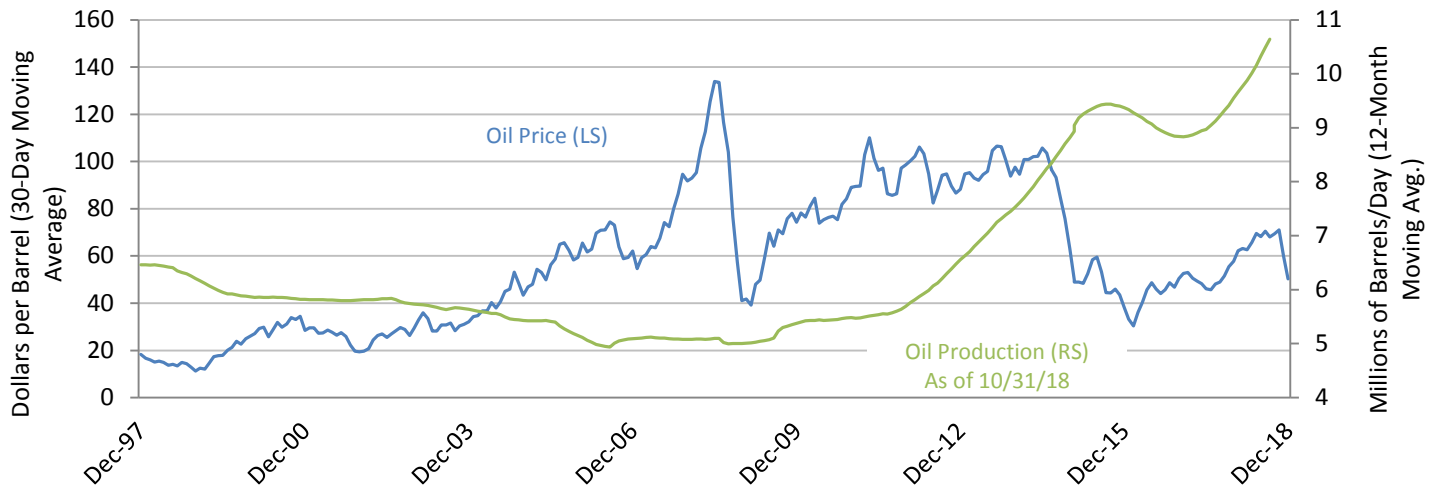
Source: U.S. Department of Commerce: Bureau of Economic Analysis

Price of Gold & Inflation Adjusted Price of Gold



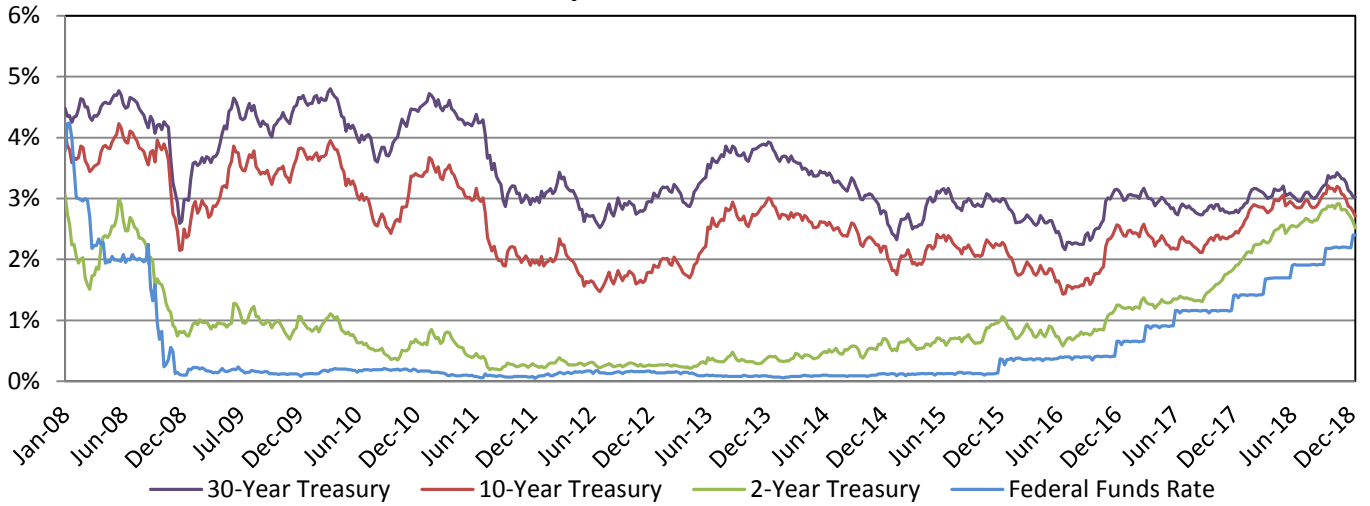
Source: Bloomberg, Inflation Adjusted Base 1984 = 100

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



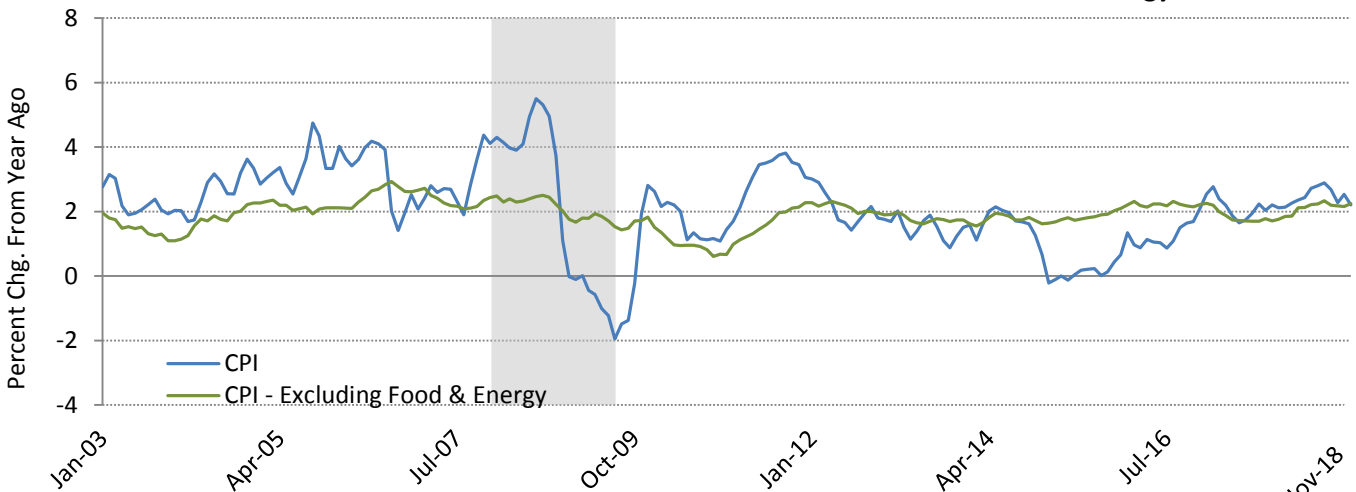
Source: Dow Jones & Company, Department of Energy

U.S. Treasury Rates & Federal Funds Rate



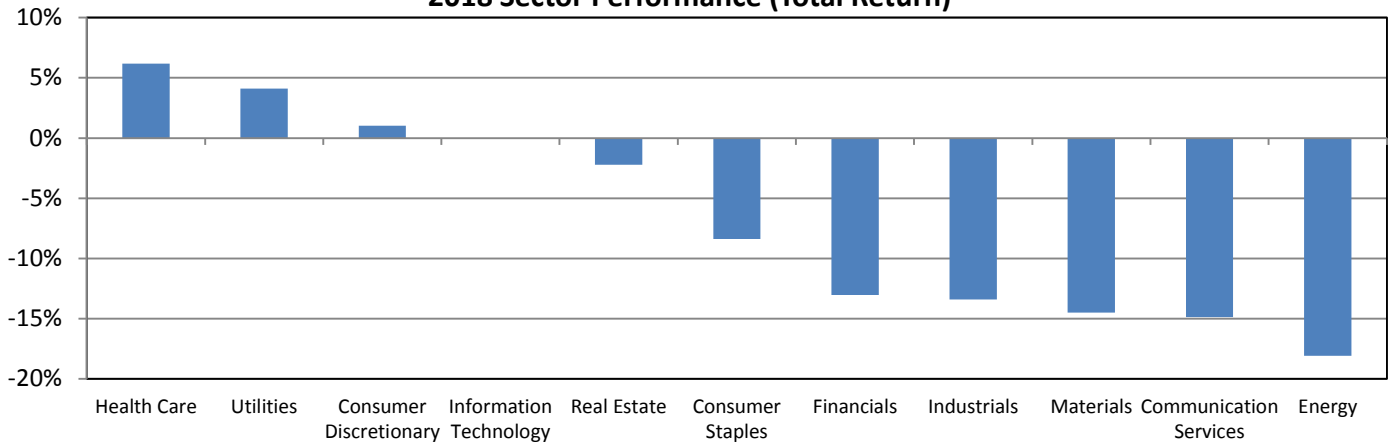
Source: Board of Governors of the Federal Reserve System

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 2018 Sector Performance (Total Return)



Source: Thomson Reuters Eikon

2019 OUTLOOK

Our baseline expectation for 2019 is for lower economic growth compared to 2018, driven by slowing global growth, tighter monetary policy, and a weakening manufacturing outlook. However, the odds of a recession in 2019 remain low as the underpinnings of the economy, such as employment, credit availability, capital expenditures, and consumer spending, all remain supportive of economic expansion. In sum, we anticipate good but not great economic growth. Capital markets are forward looking and often amplify anticipated changes in economic activity through corporate earnings estimates and Price/Earnings multiples. As a result, the downshift of real economic growth from 3.0% year-over-year to a more modest rate of around 2.0 – 2.5% for 2019 is part of what buffeted capital markets during the fourth quarter of 2018. Moreover, asset allocation shifts, many computer driven, occurred as fixed income instruments with higher yields provided an attractive alternative to volatile stocks.

The Federal Reserve will likely play a pivotal role in the trajectory of the economy over the next several quarters. The risk of a monetary policy error still remains, but it has been mitigated by Chairman Powell's recent comments that the Federal Reserve is aware of market and economic conditions. If an error in monetary policy is made, it will likely occur in one of two forms. First, the Federal Reserve overtightens, pushing monetary policy well into restrictive territory. In this scenario, inflation expectations would fall along with long-term bond yields, resulting in an inverted yield curve. This policy error was the chief concern in the fourth quarter of last year, particularly following the December interest rate hike. The second form of a monetary policy error would be an inverse of the first. In this case, the economy is stronger than anticipated; however, the Federal Reserve slows its pace of monetary tightening. Inflation would likely accelerate, moving well above 2.0% and inflation expectations would rise even faster. The Federal Reserve would then recognize it had underestimated the neutral rate of interest and signal further tightening with a very hawkish tone, possibly even raising rates by 0.5% at an FOMC meeting. This second alternative is unlikely in our view.

Our base case is that the Federal Reserve correctly gauges the potential for slower global economic growth against the backdrop of tightening monetary conditions, as both the Federal Reserve and the European Central Bank continue to allow securities on their balance sheets to mature without being replaced. In this scenario, the Federal Reserve will slow its current pace of monetary tightening. As a result, the Federal Reserve will likely raise interest rates twice in 2019, compared to market expectations for four hikes as recently as the third quarter of last year. The yield curve would remain fairly flat and possibly invert. However, the outcome would be akin to the 1965 monetary tightening cycle when the central bank was attempting to normalize interest rates as spending on the Vietnam

War expanded. The yield curve inverted in December of 1965 and the Federal Reserve continued to raise interest rates through November 1966 with a hawkish view due to unemployment, similar to the situation today. Stocks fell into a bear market in 1966, declining 22% from peak-to-trough without an accompanying recession. The Federal Reserve started easing monetary policy in December of 1966, after which the equity markets rallied. We see many similarities with this episode of monetary policy, capital market response, and economic activity in today's environment.

The Federal Reserve's goal is to achieve what is sometimes referred to as an economic "soft landing" as opposed to a "hard landing", or recession. Monetary policy is a relatively blunt instrument. Taking the appropriate course of action at the correct time in order to slow the economy just enough to prevent overheating and financial excesses, while not triggering a contraction in economic activity, is quite challenging. This challenge is precisely why investors are currently hyper-focused on the statements and policy making tone of the Federal Reserve. From 1994 to 1995 the central bank doubled interest rates to 6.0% and succeeded in slowing economic growth and reducing inflation. The issue today compared with the mid-1990's is that the employment market is extremely tight, although recent data suggest more people are reentering the workforce. Therefore, slowing economic growth today could result in rising unemployment compared to the mid-1990's soft landing when unemployment stabilized around 5.5%.

A lack of a resolution on tariffs, particularly related to China, will remain in sharp focus for investors in 2019. Clearly the most positive resolution would be a more equitable tariff scheme with open markets. The much less palatable alternative is rising protectionism, where countries escalate tariffs in progressive stages. This scenario projects rising raw material costs, supply chain disruptions, just-in-time manufacturing delays, and loss of end markets. We remain optimistic that the Administration will work to ameliorate trade concerns if it becomes evident that the lack of clarity around a trade framework begins to materially dent current economic activity. The uncertainty surrounding tariffs may well be the antecedent of recent weak manufacturing data in both the United States and China.

Consumer consumption represents roughly 70% of the U.S. economy, and the health of the consumer remains good. Employment is the bedrock of consumer spending, and the unemployment rate of 3.7% in November remains at cycle lows. Consumer confidence dimmed slightly in November and December of last year, following a cycle peak in October. The ratio of household debt to disposable income remains just below 100% and well below the 134% peak in December of 2007. In addition, tax refunds should be higher in 2019 compared with 2018 for most income tax filers. For the 2017 filing year, the IRS reported that 78% of the 101.1 million tax returns processed resulted in a refund that averaged \$2,864 per refund. The total amount of tax payments refunded for the 2017 filing year was \$226.6 billion and incremental refund estimates for 2018 based on the new tax schedule are \$40 –

\$60 billion. The positive consumer outlook is a key reason that we view the likelihood of a recession to be remote over the following year.

Exceptionally strong corporate earnings growth of over 22% in 2018, fueled in part by lower corporate tax rates, was offset by significant Price/Earnings multiple compression. At the beginning of 2018, the Standard & Poor's 500 Index traded for 20.1X trailing earnings. In contrast, the market currently sells for 15.4X trailing earnings. This 23% decline in the multiple that investors were willing to pay for earnings perfectly paced the level of multiple contraction in the last prolonged period of monetary tightening in 2004 – 2006. In essence, the market priced in a full Federal Reserve tightening cycle in 2018. Despite slowing international and domestic economic growth, we remain constructive on the U.S. equity market for 2019. It is rare for the equity market to fall in two or three consecutive years, having occurred only twice since World War II: 1973 – 1974 and 2000 – 2002. The capital markets are likely to continue to display characteristics of a late cycle economy. However, the fundamental underpinnings of the economy continue to point to the current expansion becoming the longest in modern history by this summer. Finally, as we enter 2019 investors will be challenged to navigate a litany of issues whose outcome has the potential to significantly impact the economy both positively and negatively. The current government shutdown, China trade tariffs, Mueller Investigation findings, and Brexit are but a few of the items to be carefully watched.

FINANCIAL MARKET TOTAL RETURN*

	Fourth Quarter 2018	Six Months Ending 12/31/18	One Year Ending 12/31/18	Annualized Return Two Years Ending 12/31/18	Annualized Return Three Years Ending 12/31/18	Annualized Return Five Years Ending 12/31/18
Standard & Poor's 500 Index	(13.52%)	(6.85%)	(4.38%)	7.93%	9.26%	8.49%
Russell 2000 Index	(20.20%)	(17.35%)	(11.01%)	1.00%	7.36%	4.41%
Value Line Composite Index	(18.52%)	(16.21%)	(14.27%)	(1.44%)	4.00%	1.31%
Dow Jones Industrial Average	(11.31%)	(2.77%)	(3.48%)	11.20%	12.94%	9.70%
NASDAQ (OTC) Composite	(17.28%)	(11.14%)	(2.81%)	12.27%	11.16%	11.06%
Bloomberg Barclays Capital Gov't/Credit Intermediate Bond Index	1.65%	1.87%	0.88%	1.51%	1.70%	1.86%

* Total Return Includes Income

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January 3, 2019

IMPORTANT INFORMATION

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