LUTHER KING CAPITAL MANAGEMENT

FIRST QUARTER 2019 REVIEW

Financial conditions tightened considerably toward the end of last year as the Federal Reserve increased its target interest rate, credit spreads widened and equity prices fell. In response, the global central banks have adopted a dovish outlook for monetary policy which should deter a further deterioration in the outlook for global economic growth. Domestically, the current business cycle is likely to become the longest on record by this summer. The typical business cycle is characterized by an economy moving through a series of stages: early cycle, when growth accelerates strongly following a recession; mid-cycle, as an economy approaches and then exceeds full capacity and growth peaks; and late cycle, as economic growth slows and tightening monetary policy often precipitates a recession. In many aspects, characteristics of the United States economy suggest that we remain in the mid-cycle.

The anticipation of slowing economic growth last year, aggravated in part by trade tensions, was abruptly discounted by the equity market late last year. Contributing to the downdraft was the end-of-year timing which exacerbated tax loss selling. While the global economic growth outlook has been downgraded, there are already signs that improvement may lay ahead. First, the downward trend in the global growth rate has begun to reverse. Second, container shipping rates are beginning to rise, indicating a pickup in the transport of a wide variety of finished goods.

Central banks around the world have noted the deceleration of economic growth and have altered their forward guidance in response. The Federal Reserve has become considerably more accommodative in its recent outlook, dramatically lowering the risk of a policy error in the form of over tightening monetary policy into the teeth of slowing economic growth. The Federal Reserve's indication that it will pause its current pace of four interest rate hikes per year was warmly embraced by the equity market and contributed to one of the best quarterly performance of the Standard & Poor's 500 Index in twenty years.

ECONOMY

In many ways, the current economic landscape is reminiscent of the period from 1994 to 1995. During that period, the Federal Reserve tightened monetary policy considerably from February 1994 through February 1995 - doubling the Federal Funds rate from 3.0% to 6.0%. This monetary tightening contributed heavily to the near recessionary economic growth recorded in early 1995. By July of 1995, the Federal Reserve began to reverse course, cutting interest rates twice before the end of the year. At the time, there was a special investigation surrounding President Clinton and a potential trade war with Japan was brewing as the U.S. threatened to place a 100% tariff on Japanese luxury auto imports. The pivot by the Federal Reserve to dovish monetary policy was central to the reacceleration of economic growth in the back half of 1995 and beyond.

The Federal Reserve's decision to raise its target interest rate by 1.0% to 2.5% over the course of 2018 amidst waning global economic growth and sputtering trade negotiations resulted in a general tightening of financial conditions reflected in higher credit costs. In the wake of the Federal Reserve Chairman Powell's recent remarks, the Federal Reserve intends to cease quantitative tightening by year-end. Additional guidance provided for interest rate increases this year has fallen to zero from two projected as recently as last December. This dovish outlook by the central bank has resulted in a loosening of financial conditions in the first quarter of 2019, which is supportive of equity values.

The key economic question domestically is whether consumer spending and business investment can continue to fuel economic growth as fiscal stimulus fades. Each of these sectors of the economy has demonstrated recent signs of stress. A slump in December retail sales was the largest in a decade but was followed by a rebound in January, as consumer confidence ticked higher and concerns over the government shutdown and equity market receded. Wage growth adjusted for inflation grew 1.4% year/year in February, the greatest pace of growth since late 2010. Business investment accelerated through the first three quarters of last year. However, capital expenditures related to new orders dipped late last year alongside a decline in business confidence driven by concerns over tariffs, the government shutdown, lower energy prices, and rising interest rates. We anticipate a rebound in business investment in 2019, although perhaps not to the levels recorded last year.

Economic growth outside the United States remains weak overall. The European Central Bank recently lowered its forecast for economic growth this year to 1.1% from 1.7% previously. As a result, the European Central Bank held its benchmark refinancing rate at 0% at its March meeting and pushed out the timing of its first rate hike in nearly eight years to 2020 at the earliest. Similarly, the Bank of Japan left its key short-term interest rate unchanged at (0.1%) in March, as widely expected. Policymakers also kept the target for the 10-year Japanese government bond yield at around zero percent, but offered weaker views on exports and output amid rising global headwinds.

In the immediate aftermath of the Great Recession, many market observers suggested that a prolonged period of ultra-low interest rates and ballooning central bank balance sheets would lead to significant inflation and a crowding out of private sector investment. However, a lack of meaningful inflationary pressures and lack of crowding out of investment have given rise to the question of whether governments should run larger deficits. Modern Monetary Theory is one variant of this hypothesis and will likely be discussed more broadly in the run-up to the presidential election next year. The central tenant of the Modern Monetary Theory is that countries which have their own central banks and borrow in their own currency, such as the United States, the United Kingdom, and Japan, always have the ability to service their own debt. The outgrowth of this framework is that at a time when there is little inflationary pressure, due in part to technological innovation and aging demographics, there is a much greater capacity to run significantly larger deficits. Modern Monetary Theory is anathema to classical economic theory which suggests that the use of the printing press to satiate federal obligations leads to hyper-inflation. Our baseline outlook for the economy does not include employing Modern Monetary Theory; however, we would not be surprised to see pressure to pursue greater fiscal policy in the next downturn.

CAPITAL MARKETS

Recent falling global bond yields are the result of sluggish economic growth and low inflation around the world as well as the dovish posture of global central banks. Domestic interest rates have received a great deal of attention recently as the interest rate on the 3-month Treasury bill briefly exceeded the yield on the 10-year Treasury note. This dynamic, commonly referred to as an inverted yield curve, is indeed noteworthy as the yield curve has inverted on nine occasions since the late 1960's and following seven of those instances the economy tipped into recession within 18 months. While it may be perilous to ignore the inverted yield curve, we believe there are important contextual elements. First, we believe the yield curve would need to remain inverted for a sustained period of several months in order for us to raise our probability of a recession. Second, we believe the level of interest rates has been distorted by large purchases of debt by central banks. Finally, the correlation between the shape of the yield curve and the subsequent annual growth in real Gross Domestic Product has fallen since the early 1970's as the complexion of the economy has changed over time.

A key advantage of the recent decline in market interest rates is the opportunity for lower mortgage rates to stimulate the housing market which was decidedly weak last year. The 30-year mortgage rate has fallen almost a full percentage point to 4.0%. Historically, existing home sales have been sensitive to the change in mortgage rates over the prior six months. As a result, housing is likely to turn from a mild headwind to a mild tailwind in 2019. The housing market is a key component of consumer confidence because it is often the largest asset for most households. In that sense, housing "punches above its weight". Beginning in the second quarter, we would not be surprised to see a pick-up in housing starts and building permits. While housing affordability remains a critical issue in select urban areas, we may be in the early phase of a housing unit shortage. The average age of homes in the United States is over 30-years old and over the past decade the average age has risen at its fastest clip since the 1930's. The Millennial generation, which is now 20 to 36-years-old, is larger than the Baby Boomer generation, but has a much different profile in many respects, including housing. The low rate of household formation among Millennials, due in part to significant student debt and lower economic growth this cycle, is beginning to improve. In 2016, it is estimated that only 27% of Millennials were married compared with 38% by 2018. Home ownership for Millennials rose from 26% to 40% over the comparable time period. Housing and employment are the bedrock of consumer consumption, which represents nearly 70% of the United States economy.

Corporate earnings expanded 22% in 2018 with roughly half of the growth attributable to lower corporate tax rates. We forecast corporate earnings will grow between 5% to 7% for 2019 with the growth tilted to the second half of the year. The lagged effect of higher interest rates, slowing global growth, the government shutdown, and a Polar Vortex will likely combine to result in first quarter Standard & Poor's 500 Index earnings being lower than the comparable quarter last year. Primary industry contributors to lower corporate earnings year-over-year include autos, energy, and semiconductors. However, we anticipate overall corporate earnings will rebound in the second half of the year.

CONCLUSION

The current economic and investment climate is perhaps best characterized as "slowing". The pace of monetary tightening, economic growth at home and abroad, and corporate profits growth are all slowing. However, a key pillar of the domestic economy, personal consumption, remains healthy which should continue to be supportive of economic growth. One of the key risks to the current economic expansion in our view has been the potential for the Federal Reserve to overtighten monetary policy. This risk appears to have retreated as the central bank has indicated its willingness to refrain from further monetary policy tightening this year. As always, there is a considerable list of concerns which include near-peak corporate profit margins and rising corporate debt levels. As campaign momentum for the 2020 presidential election builds, the capital markets will begin to anticipate the eventual outcome and its implications. China continues to stimulate its economy by injecting additional credit into an already highly levered economy. Finally, the ultimate form of Brexit remains a mystery with uncertainty continuing to impact economic growth in the region.

We believe we are witnessing the third "growth scare" of the current economic expansion. While we view the probability of an economic recession as low over the balance of the year, odds are greater that we have an earnings recession – defined as two consecutive quarters of declines in corporate earnings. A portion of the decline is explained by the unfavorable base effects created by last year's reduction in domestic corporate tax rates. This phenomenon has the potential to dampen equity market returns over the final three quarters of the year. The upside, however, is that accommodative central banks may further elongate the current expansion.

*FINANCIAL MARKET TOTAL RETURN**

	First Quarter 2019	**Six Months Ending 03/31/19**	**One Year Ending 03/31/19**	**Annualized Return Two Years Ending 03/31/19**	**Annualized Return Three Years Ending 03/31/19**	**Annualized Return Five Years Ending 03/31/19**
Standard & Poor's 500 Index	13.65%	(1.72%)	9.50%	11.72%	13.51%	10.91%
Russell 2000 Index	14.58%	(8.56%)	2.05%	6.81%	12.92%	7.05%
Value Line Composite Index	13.39%	(7.61%)	(0.52%)	3.26%	7.68%	3.55%
Dow Jones Industrial Average	11.81%	(0.84%)	10.09%	14.64%	16.37%	12.21%
NASDAQ (OTC) Composite	16.81%	(3.38%)	10.66%	15.69%	18.06%	14.39%
Bloomberg Barclays Capital Gov't/Credit Intermediate Bond Index	2.32%	4.01%	4.24%	2.28%	1.66%	2.12%

** Total Return Includes Income*

Michael C. Yeager, CFA
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