

LUTHER KING CAPITAL MANAGEMENT

THIRD QUARTER 2019 REVIEW

As it telegraphed in the first quarter, the Federal Reserve Bank reversed course and eased monetary policy for the first time since December 2008 in response to slowing economic growth and rising trade friction. Chairman of the Federal Reserve Bank, Jerome Powell, characterized the shift in monetary policy as a “mid-cycle” adjustment. Lower interest rates helped lift equity prices to a new high in July as measured by the Standard & Poor’s 500 Index. Equity prices retreated in August as both sides in the long-simmering trade war with China appeared to harden their respective positions, with equity prices lifting slightly in September to close the quarter with an advance of 1.70%.

Investors continue to see bond yields decline both at home and abroad. Global central banks are the architect of negative bond yields as the European Central Bank and the Bank of Japan continue to purchase bonds in the open market, often referred to as “quantitative easing”. The upward pressure on bond prices exerted by central bank purchases results in falling bond yields. At an extreme, bond prices can rise to the point that the yield on a bond becomes negative, meaning the buyer of the bond is guaranteed a capital loss if the bond is held to maturity. German sovereign bonds traded at negative yields across the entire yield curve during the quarter, which contributed to the downward pressure on domestic yields as global investors seek to hold U.S. Treasuries at relatively attractive yields. In the process, the U.S. 30-Year Treasury bond yield reached a record intraday low of 1.90% this quarter, which also marked the first time since 2009 that the dividend yield of the Standard & Poor’s 500 Index exceeded the yield on the long-dated U.S. Treasury bond.

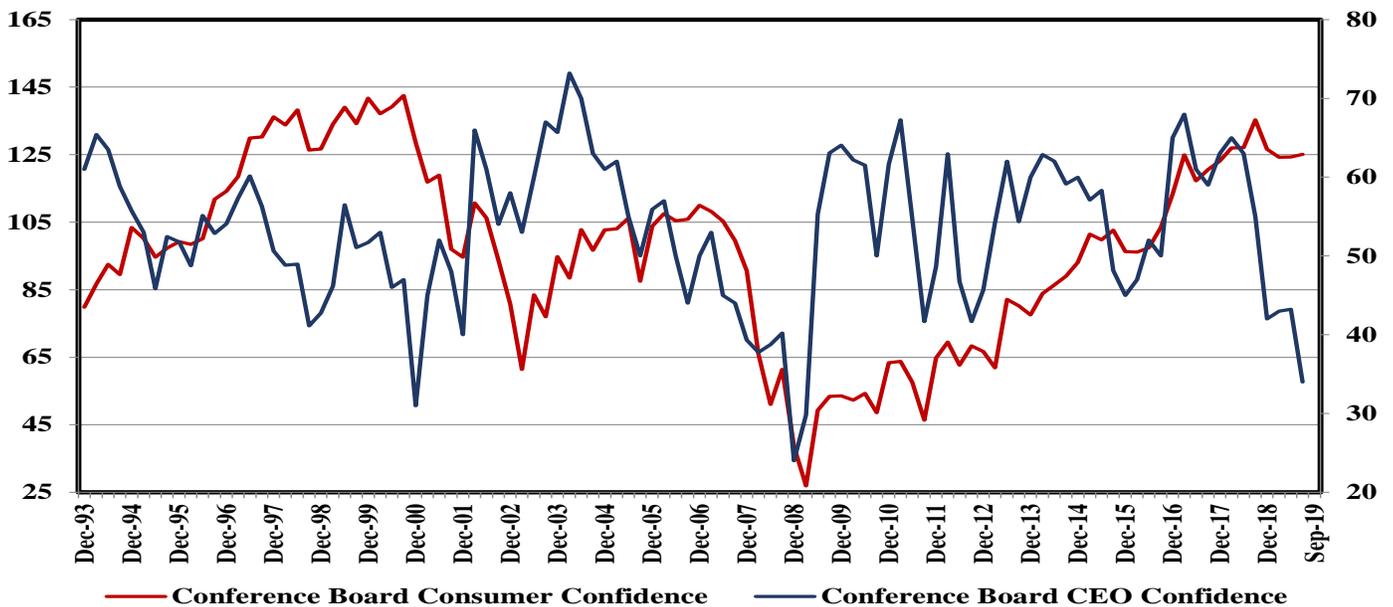
The current U.S. economic expansion remains the slowest in post-war history. When economic growth fell below two percent in prior economic cycles, it nearly guaranteed the economy entered into a recession. Because the current expansion is remarkably tepid, the economy has been prone to periods when economic growth slowed to the aviation equivalent of a stall speed. When economic output slows to the rate of one to two percent, the economy and capital markets logically are more vulnerable to tipping into contraction and

less able to absorb an exogenous shock to the system. We are currently experiencing the third such stall in economic growth this cycle. While the economy is certainly more vulnerable during these periods, current monetary easing in the pipeline will likely avert a near-term recession in our view.

ECONOMY

There are two competing elements within the domestic economy at the moment. The first is the sustained health of the consumer bolstered by generational low unemployment, real wage growth, reasonable levels of household debt to disposable income, and a relatively high savings rate. The second is the decline in manufacturing activity and industrial production accentuated by a trade war, strong U.S. dollar, and slowing global economy. To date, the net impact of these two elements is positive economic growth because personal consumption represents a much greater portion of the domestic economy than does manufacturing. However, the enduring trade war has the potential to erode one of the primary pillars of personal consumption – consumer confidence. A sudden drop in confidence can generate a self-fulfilling negative cycle where rising pessimism leads to less consumer spending, rising unemployment, lower corporate profits, and even deeper pessimism. In addition, a sense of eroding confidence is beginning to develop in corporate boardrooms due to shifting trade policy and overall economic uncertainty. The chart below highlights the recent divergence between consumer confidence and CEO confidence.

U.S. CONSUMER AND CEO CONFIDENCE



Source: Conference Board, Bloomberg, Furey Research, LKCM

While manufacturing activity represents only slightly more than ten percent of Gross Domestic Product (GDP), it is a very volatile component of the economy and therefore receives a great deal of attention from investors. One measure of the health of domestic manufacturing, industrial production, fell for two consecutive quarters in the first half of this year with little improvement anticipated when the Federal Reserve Bank releases its third quarter report. The last time the economy posted consecutive quarters of shrinking industrial output was in the first two quarters of 2016 in the run-up to the presidential election. The country lost almost 30,000 manufacturing jobs that year as a collapse in oil prices filtered through to manufacturing which has a great deal of parallels with the current economic slowdown with one key difference - a trade war.

The decline in industrial production is emblematic of a slowing domestic and global economy, exacerbated by the current trade war, which may be more aptly characterized as an “investment war”. There is little doubt that rising uncertainty regarding tariff schedules has had a chilling effect on capital investment which has implications for future economic growth. While economic growth is likely to continue to slow in the fourth quarter and remain lackluster in the first quarter of next year, leading economic indicators are likely to turn higher by the spring based on the past relationship between interest rates and the economy. Historically, interest rates impact leading economic indicators with an 18-month lag on average.

CAPITAL MARKETS

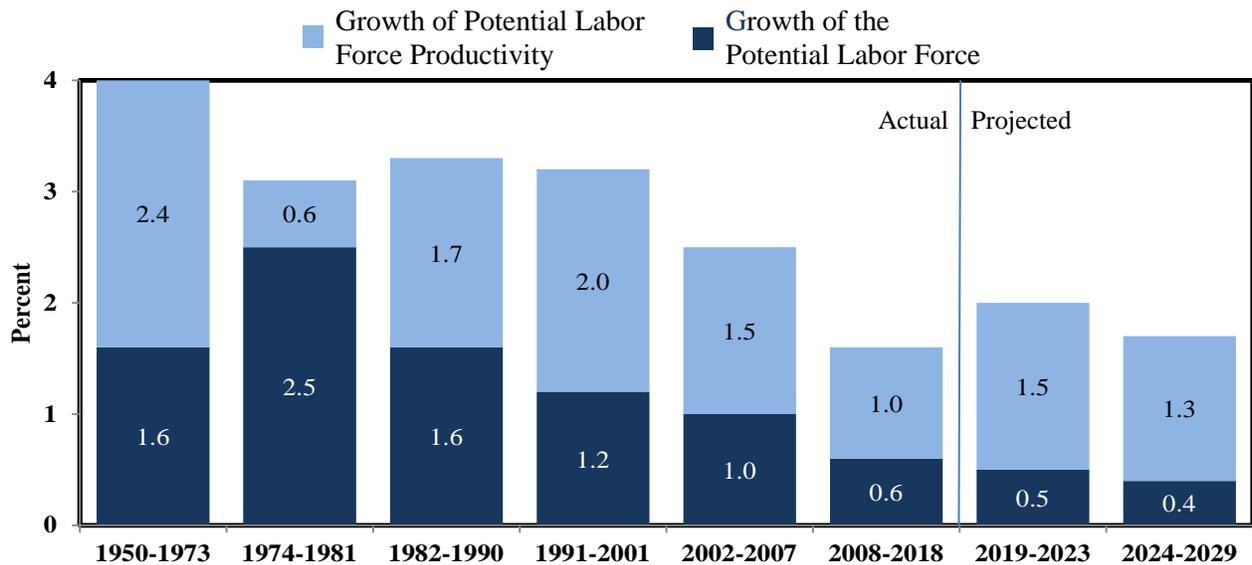
The unemployment rate for September fell to 3.5%, a level last seen in December 1969. While this bolsters the case for continued consumer confidence and therefore consumer spending, it presents a puzzling economic question. How much further can the unemployment rate fall before pushing wages higher? The unemployment rate has declined from a peak of 10.0% this cycle to 3.5% currently and inflation remains stubbornly below the Federal Reserve Bank’s 2.0% target. Prior to falling below the 4.0% threshold last year, the two previous periods in which the unemployment rate fell through 4.0% were 2000 and 1969. In both cases the economy entered a recession the following year, precipitated in part by the tightening of monetary policy in response to an increase in perceived inflation risk which ultimately curtailed consumer spending, prompted layoffs, and led to a recession.

At any given time, the economy is subject to both long-term trends and short-run influences. Long-term trends, or structural factors, include demographics, fiscal health, and composition of the economy between the manufacturing and service sectors. In contrast, cyclical factors often include inflation, interest rates, and foreign growth (exports). The focus of market participants is often skewed to cyclical factors and their

implication for near-term growth. However, demographics may well influence the pace of economic growth and therefore interest rates in the not too distant future.

Lower levels of policy interest rates are common to aging developed economies due to lower inflationary pressures, including wages. While real GDP growth exceeded 4% annually from 1997 to 2000, the number of Americans in the 20 to 64-years old group grew by 2.3 million annually, on average. Next year, the same group is forecast to rise by about 345,000 – a record low dating to 1921. This secular dynamic has implications for future economic growth as well as the future path of interest rates. The Congressional Budget Office (CBO) recently updated its projections of potential GDP in which it parsed the contribution of workforce growth and productivity. We have been focused on the importance of capital investment as a linchpin of future productivity growth, given the lack of support workforce growth will play in spurring future economic activity. Not surprisingly, in the January 2019 CBO outlook, the agency acknowledged the long-term impact of recent trade policies will lead to lower real private investment, and in turn, potential output.

U.S. REAL POTENTIAL GDP GROWTH



Source: Congressional Budget Office

It is important to note that this is not the CBO’s forecast of the level of real GDP, but rather a projection of the economy’s output with a high usage rate of its capital and labor resources. The economy is well capable of growing faster than its estimated potential, as it did in 2018. In essence, real potential GDP is a measure of the trend in actual GDP that smoothes out business cycle fluctuations. Potential GDP is one of several important inputs for monetary policymakers. When the economy is expanding below its potential, known as a

negative output gap, it suggests that easier monetary policy might be warranted in order to spur economic growth.

The Federal Reserve Bank reduced its key interest rate by 0.25% in September, following the initial cut in July - the first interest rate reduction in ten years. We recently visited with former New York Federal Reserve Bank president, William Dudley, who remarked that one of the key lessons from the Japanese economic malaise is that when the capacity for monetary policy to operate is limited, it is better to act early than late. His analysis indicates the dovish pivot by the U.S. central bank ensures against downside risk. At worst, if the Federal Reserve Bank has misjudged the health of the economy, easy monetary policy could ignite higher inflation, which the Federal Reserve Bank would eventually have to address. However, following nearly twelve years of inflation readings below the Federal Reserve Bank's implied 2.0% target, somewhat higher inflation, from this perspective, would be a welcomed outcome.

As previously mentioned, global bond yields continued to fall around the world during the third quarter, which has implications for economic growth longer-term. Sub-zero sovereign bond yields in Europe and Japan were brought about by teetering economic growth, low inflation, and aggressive central bank stimulus, including negative policy rates and large-scale asset purchases. Falling global interest rates have pushed a substantial amount of global sovereign debt into negative yielding territory. This dynamic peaked in late August when over \$17 trillion of debt globally traded at a negative yield, representing roughly a quarter of outstanding government debt. Excluding the U.S., nearly one-half of sovereign bonds yielded a negative interest rate. Unfortunately, sub-zero yields have yet to lead a near-term economic revival. The long-term implications of punishing savers and crimping bank profitability are troublesome. The European Central Bank and the Bank of Japan both lowered key interest rates during the third quarter, with little course change in sight as central banks are incited to continue reducing rates in an effort to support their economies by weakening their currencies relative to the U.S. dollar.

CONCLUSION

Whether the longest economic expansion in American history remains intact may depend on the degree to which consumers are able to maintain spending in order to offset a slump in manufacturing activity exacerbated by a trade war and strong U.S. dollar. If a fading manufacturing sector in the U.S. and the Eurozone prove a leading indicator of weakness in the larger services sector, the downturn will be more widespread.

If history is a guide, global growth should stabilize and begin to recover early next year as the lagged effects of easy monetary policy stimulate the economy. It is important to recall that the Federal Reserve Bank was tightening monetary policy less than a year ago. A further reduction in U.S. policy rates may halt the ascendant U.S. dollar which would boost the foreign earnings of U.S. corporations. We anticipate the weakest year-over-year growth in corporate earnings this year will occur in the third quarter when corporate earnings growth is expected to be roughly one percent. Corporate earnings growth should accelerate beyond the third quarter as comparisons to the fourth quarter of 2018 and first quarter of 2019 earnings become easier. We remain constructive on the economic and capital markets outlook, but acknowledge that when economic growth is close to stall speed, consumer confidence can become vulnerable and the risk to an outside shock to the economy is higher.

FINANCIAL MARKET TOTAL RETURN*

| | Third Quarter 2019 | Nine Months Ending 09/30/19 | One Year Ending 09/30/19 | Annualized Return Two Years Ending 09/30/19 | Annualized Return Three Years Ending 09/30/19 | Annualized Return Five Years Ending 09/30/19 |
|---|-----------------------------------|--|---|--|--|---|
| Standard & Poor's 500 Index | 1.70% | 20.55% | 4.25% | 10.87% | 13.39% | 10.84% |
| Russell 2000 Index | (2.40%) | 14.18% | (8.89%) | 2.47% | 8.23% | 8.19% |
| Value Line Composite Index | (1.87%) | 11.88% | (8.84%) | 0.25% | 4.55% | 3.79% |
| Dow Jones Industrial Average | 1.83% | 17.51% | 4.21% | 12.18% | 16.44% | 12.28% |
| NASDAQ (OTC) Composite | 0.18% | 21.56% | 0.55% | 12.19% | 15.94% | 13.59% |
| Bloomberg Barclays Capital Gov't/Credit Intermediate Bond Index | 1.37% | 6.41% | 8.17% | 3.50% | 2.40% | 2.68% |

** Total Return Includes Income*

Michael C. Yeager, CFA
October 3, 2019

IMPORTANT INFORMATION

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