LUTHER KING CAPITAL MANAGEMENT

THIRD QUARTER 2020 REVIEW

The economy continues to recover from the first half COVID-19 shock, although the recovery has been uneven and is likely to slow in the absence of fresh fiscal stimulus. The Federal Reserve has done exceedingly well ensuring the economy remains primed with ample liquidity. Perhaps the central bank has done too well, as the sense of urgency by lawmakers to continue to support the consumer appears to be fading. The Chairman of the Federal Reserve, Jerome Powell, seemed to say as much in a September press conference in which he remarked the central bank has “lending power” but not “spending power.” This public nudge of fiscal policymakers is important, as consumers along with small business face a benefits cliff at a time when the economy is beginning to show some early signs of deceleration.

Despite the potential for the economy to cool going forward, consumer confidence posted its biggest monthly gain in seventeen years in September, and this optimism was well founded. The housing market strengthened considerably (despite a concomitant increase in mortgage delinquencies), which translates into more spending on household durable goods such as furniture and appliances. In fact, consumer spending is already growing faster than production, meaning inventories that are already low from pandemic shutdowns will need to be replenished. The restocking cycle will likely be a key investment thesis for 2021. Normally in a recession, areas of the economy related to goods fare much worse than the service components of the economy because firms have to shutter production to work off excess inventory. The social distancing nature of this recession has reversed this normal pattern. Services continue to lag, but they should slowly improve - particularly once a vaccine is widely available.

The equity market, as measured by the Standard & Poor’s 500 Index, has advanced 5.6% through the first three quarters of this year driven by central bank liquidity, fiscal stimulus, and the capitalization-weighted nature of the index. In fact, if you were to equally weight the constituents of the Standard & Poor’s 500

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Index, the composite would tell a very different story with a year-to-date decline of 4.8%. As we discuss below, the top five largest companies in the Standard & Poor's 500 Index represent a disproportionate share of the market's return through the first three quarters of the year. The record concentration means the index has never been more dependent on the continued strength of its largest constituents or more vulnerable to an idiosyncratic shock to any of these companies.

ECONOMY

The swift and severe shock of a once-in-a-lifetime pandemic and shutdown measures to combat the coronavirus initially brought about sharp contractions in personal consumption, exports, inventories, investment, and spending by state and local governments. This culminated in the deepest quarterly economic contraction in over a century during the second quarter. Unfortunately for many restaurants and bars, movie theaters, airlines, car rental companies, retailers, and gyms, the recession of 2020 will be an extinction event. Well-recognized brands such as Hertz, J.C. Penney, J. Crew, Brooks Brothers, Neiman Marcus, Lord & Taylor, GNC, Pier 1, and Stein Mart have filed for bankruptcy this year. Despite acute pain in select individual businesses and industries, there has not been significant damage to the financial system. Banks are well-capitalized, and a combination of extremely easy monetary policy and large government transfers have forestalled a wave of defaults that might otherwise have occurred.

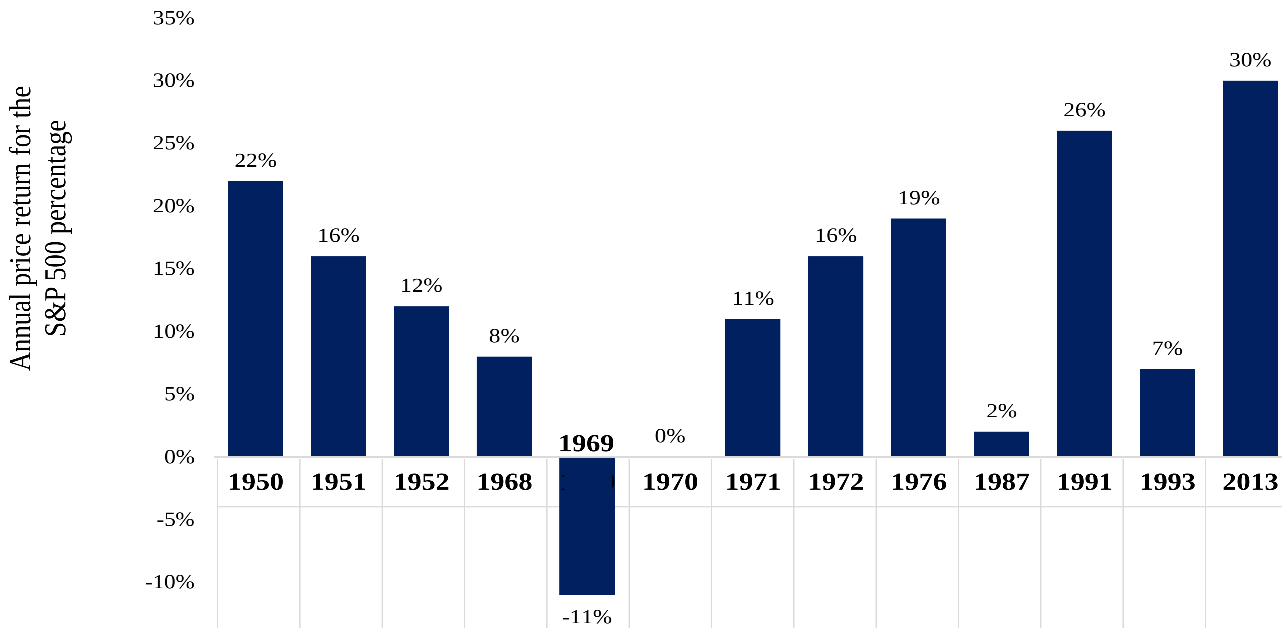
By issuing checks to more than half of all taxpayers, the CARES Act both arrested April's free fall in consumption and produced a rise in personal income levels amidst a recession. Direct payments of $1,200 for every adult and $500 for every child to households earning less than $99,000 ($198,000 for married taxpayers filing jointly) and weekly $600 supplemental unemployment benefits payments helped push up real personal income 16.5% in April, compared with a year earlier. Without the full complement of usual spending opportunities available, the government transfer payments contributed to a record jump in the personal savings rate. The $325 billion that households accumulated in savings from March through July helped tide them over in August and September. A key risk that we are watching carefully is the potential waning of unemployment benefits and other forms of fiscal relief, which could cause more typical recessionary damage to emerge and truncate the economic recovery. Agreement on a new round of fiscal stimulus, which appears less likely prior to the elections as we write this note, will be critical following the election.

The Presidential and Congressional elections loom larger on the horizon than is usual, not only due to an environment of hyper-partisanship, but also related to the nature of the election itself. The portion of the electorate that cast ballots prior to Election Day has steadily risen in recent elections and represented four in ten votes in 2016, mainly through mail-in ballots. Polls have suggested over one-half of votes could be cast prior to Election Day this year due to the pandemic. Further, surveys show that a greater share of Democrats plan to vote by mail than Republicans. In a close decision, this could lead to a situation where the President is leading on election night based on in-person voting, but slowly relinquishes the lead as mail-in ballots are counted in the days following the election. Furthermore, several closely contested states such as Wisconsin, Michigan, North Carolina, and Pennsylvania have a Democratic governor and Republican-controlled state legislatures which may battle over the legitimacy of mailed ballots. Collectively, this suggests that there is a possibility we will not know the Presidential winner for some period following Election Day. We would not be surprised to see increased volatility in the capital markets as we approach Election Day, which would be consistent with similar periods.

Once the dust has settled from the election, investors will have a new set of circumstances to factor into their investment decisions. Fiscal spending, taxation, regulation, and trade are a few of the areas that may undergo change. In our view, the immediacy of an additional fiscal stimulus package will be important for the economy. On the other side of the ledger, we most often hear clients cite higher taxes as a primary concern for the economy and the equity market. While tax policy is an important determination of long-term economic growth, it is one of several important inputs.

Taxes are most commonly grouped into one of three categories: corporate, personal, and capital gains. Sizable tax increases are exceedingly rare and only twice in the past seventy years have tax rates increased in each category at the same time, occurring in 1968 and 1993. Currently, the top corporate tax rate is 21%, the top marginal personal income tax rate is 37%, and the top long-term capital gains tax rate is 20%. Depending on who wins the presidency and which parties control Congress, a Democratic tax plan would likely reverse tax relief provided by the Tax Cuts and Jobs Act, which went into effect in 2018. However, history demonstrates higher taxes do not translate into poor equity returns in the same calendar year as a tax change. The chart on the following page illustrates each increase in personal, corporate, or capital gains tax rates since 1950 alongside the performance of the Standard & Poor’s 500 Index.

Tax Increases Through the Years



Tax Rate Increase in:	1950	1951	1952	1968	1969	1970	1971	1972	1976	1987	1991	1993	2013
Personal	✓	✓	✓	✓	✓						✓	✓	✓
Corporate	✓	✓	✓	✓								✓	
Capital Gains				✓	✓	✓	✓	✓	✓	✓	✓	✓	✓

Source: Haver, FMC, LKCM

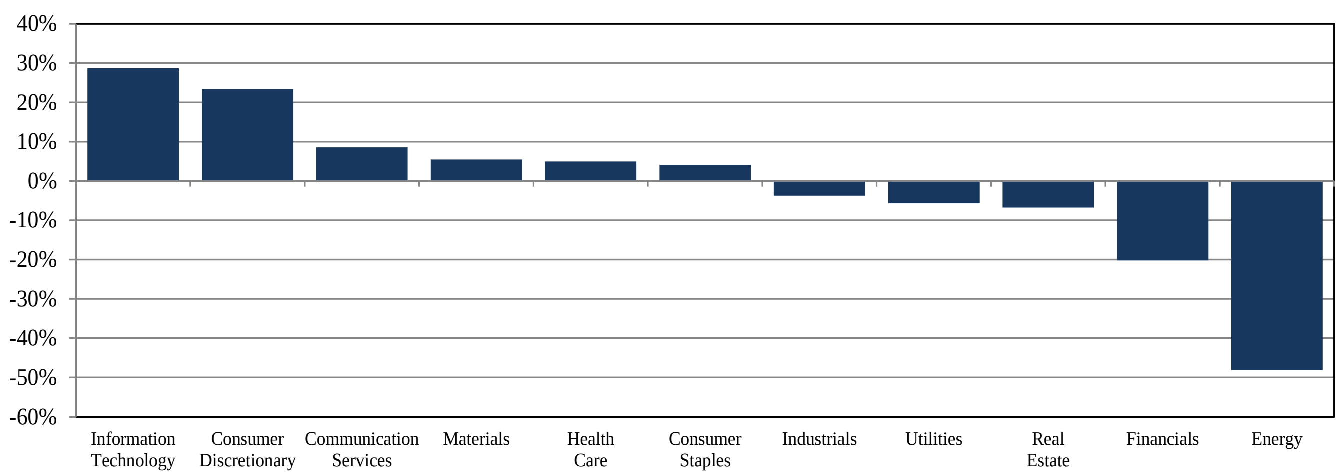
Not only has the equity market risen in each of the five years in which there has been an increase in the corporate tax rate since 1950, the equity market has also gained in the year preceding the tax increase. Why would the equity market rise in tandem with higher taxes? Because taxes represent only a single, although undoubtedly important, element of a complex dynamic. For example, periods in which tax rates increase are often accompanied by increases in fiscal spending and often changes in monetary policy. At this time, forecasting the economic impact of a potential increase in tax rates for corporations or individuals is challenging; neither the tax policy, nor the fiscal policies of a new administration, has been clearly delineated or, more importantly, are guaranteed passage into law.

CAPITAL MARKETS

Equities tend to rise when the economy is expanding. In this way, the equity market is a barometer of anticipated economic growth, focusing more on whether economic conditions are incrementally "better" or "worse," rather than simply "good" or "bad." Because the equity market moves in advance of the economy and corporate earnings, the recent rise in equity prices ultimately must be supported by greater economy activity and higher corporate earnings. We expect real GDP growth in 2021 to be above trend, propelled in part by new fiscal stimulus and a record inventory restocking cycle. We forecast this economic growth will propel an approximate 25% rebound in Standard & Poor's 500 Index corporate earnings next year, which would confirm the recovery we have witnessed in equity prices this year. Of course, this favorable forecast could easily be pushed off course by a sharp worsening of the pandemic, a fiscal policy error, or the delay of successful vaccines.

The equity market recovery has been as unique as the economic recession this year. A typical market recovery is broad-based and led by the most economically sensitive segments of the market such as Energy, Financials, and Industrials. Yet, year-to-date, these are the three worst performing sectors of the Standard & Poor's 500 Index, excluding the very interest rate sensitive sectors of Utilities and Real Estate.

Standard & Poor's 500 Index
2020 (01/01/20 - 09/30/20)
Sector Performance (Total Return)



Source: Thomson Reuters Eikon

Instead, the market leadership has been equities of the least economically sensitive secular growth companies. For the Standard & Poor's 500 Index, which weighs company performance contribution based on the size of the company, a strong showing by a small handful of very large stocks has resulted in a situation that we would describe as a very "narrow" market. Five technology focused companies- mentioned earlier: Apple, Microsoft, Amazon, Facebook, and Alphabet (parent company of Google) - represent nearly 23% of the Standard & Poor's 500 Index market capitalization, eclipsing the 18% concentration of the top five stocks at the peak of the Technology Bubble in 2000. These five companies have returned 45.4% on a weighted average basis for the first three quarters of the year. This stands in stark contrast to the overall performance of small companies as represented by the Russell 2000 Index, which has declined 8.7% through September. One reason for the strong performance of secular growth companies is because they generally have faster sales and earnings growth, stronger margins, less debt, and reinvest more in their businesses relative to many more traditional cyclical parts of the economy.

Changes in market leadership often accompany economic regime shifts in inflation expectations, interest rates, and economic growth prospects. A potential catalyst for a pivot to more cyclical parts of the economy would be a significant fiscal stimulus injection that effectively increases activity and broadens the recovery to cyclical parts of the economy. A reversal in nationalistic trade policies could also increase earnings potential for more economically sensitive companies with meaningful revenue from overseas. Whether the election emerges as the catalyst, we anticipate that an economic regime shift will likely include a lift in the long end of the U.S. Treasury yield curve and a possible reduction in the valuation premium currently afforded growth stocks.

We remain broadly constructive on equities, although earnings multiples are historically high, near 20X for estimated 2021 Standard & Poor's 500 Index earnings. The inverse of the earnings multiple, or earnings yield, of the equity market is 5%, which is attractive relative to the yield in the fixed income market such as 0.69% for a 10-Year U.S. Treasury note. A key component to our outlook is that domestic and global monetary stimulus, which has well exceeded that of the Great Financial Crisis of 2008 – 2009, is not likely to be withdrawn for a long time. Regarding fiscal policy, we do not anticipate a repeat of the aftermath of the Great Financial Crisis when Congress attacked the fiscal deficit in response to pressure from the Tea Party, and the Eurozone turned to austerity to deal with its sovereign debt crisis.

CONCLUSION

Consumers remain the economic growth engine in our country and a full economy recovery will not be complete without them, which makes the delivery and adoption of a vaccine important in the coming year. While there has been a sharp improvement in the headline unemployment rate from a peak of 14.7% to 7.9% by last measure, the permanent job loss data is worrisome. If the unemployment rate continues to fall, there is a risk that fiscal policymakers are lulled into thinking that additional support is not needed. Lack of some additional fiscal stimulus would likely curtail the economic recovery and represent a significant policy error in our judgement.

While there is always a long list of concerns for investors, we recognize that the current list is quite unique for its wide scope. The elections in November have the potential to alter the landscape for fiscal spending, taxes, regulation, and trade with implication for equities, fixed income, and the U.S. dollar, which will all unfold as the northern hemisphere approaches winter and a potential pandemic resurgence. Of course, there are key mitigation factors such as a meaningful fourth fiscal stimulus package and a coronavirus vaccine. Regardless of what awaits investors in the coming months, for over forty years we have remained true to our investment discipline of owning what we believe to be high quality, competitively advantaged companies with strong cash flows and sound balance sheets.

*FINANCIAL MARKET TOTAL RETURN**

	Third Quarter 2020	Nine Months Ending 09/30/20	One Year Ending 09/30/20	Annualized Return Two Years Ending 09/30/20	Annualized Return Three Years Ending 09/30/20	Annualized Return Five Years Ending 09/30/20
Standard & Poor's 500 Index	8.93%	5.57%	15.15%	9.57%	12.28%	14.15%
Russell 2000 Index	4.93%	(8.69%)	0.39%	(4.36%)	1.77%	8.00%
Value Line Composite Index	3.97%	(15.78%)	(10.25%)	(9.55%)	(3.38%)	2.90%
Dow Jones Industrial Average	8.22%	(0.91%)	5.70%	4.95%	9.98%	14.02%
NASDAQ (OTC) Composite	11.23%	25.40%	41.06%	19.10%	21.10%	20.71%
Bloomberg Barclays Capital Gov't/Credit Intermediate Bond Index	0.62%	5.92%	6.32%	7.24%	4.43%	3.39%

* *Total Return Includes Income*

Michael C. Yeager, CFA
October 2, 2020

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