

LUTHER KING CAPITAL MANAGEMENT

FIRST QUARTER 2021 REVIEW

We anticipate the global economy will strongly rebound this year, as the pandemic recedes with broader vaccine distribution. The economic reopening should finally revive the ailing service sector, thus adding to a recovery that has already been underway in manufacturing. The services recovery could lead the domestic economy to expand at the fastest pace in nearly four decades, eclipsing the 7.2% expansion in 1984 that was driven in part by heavy inventory restocking following a sharp rebound in consumer spending on the heels of the 1982 recession. This pattern looks remarkably familiar to us today. Inventory levels are currently very lean as public health measures resulted in manufacturing being shuttered which laid bare the fragility of a global “just-in-time” inventory web. Even as management teams bring production back online, logistics remain in disarray as evidenced by significant port congestion and increases in transport costs.

The services portion of the U.S. economy, which includes industries such as banking, health care, information technology, travel, and restaurants, represents 45% of the nation’s economic output. Businesses in some service industries have been especially hard hit with social distancing requirements. One year ago, weekly initial jobless claims climbed to 6.6 million people, the highest figure on record by a wide margin. The report represented a ten-fold increase from the previous high of nearly 700,000 lost jobs during the Reagan-era recession in October 1982. As implied above, most of these jobs were lost in the service industry, which accounts for more than 80% of total U.S. jobs. Employment data should continue to improve as the services economy rebounds, underpinning consumer confidence and supporting consumption.

The equity market, as measured by the Standard & Poor’s 500 Index, rose 6.2% during the first quarter, including dividends. The bond market, however, declined during the first quarter as market interest rates have risen sharply in anticipation of accelerating economic growth and the prospect of higher inflation.

Long duration bonds, such as the 30-Year Government Bond, had a negative total return of 16.3% during the first quarter. Rising interest rates are consistent with our economic outlook, and we have therefore intentionally focused on short duration bonds in client portfolios.

ECONOMY

The U.S. economy produced \$21.4 trillion worth of goods and services in the year leading up to the pandemic. Each economic cycle is unique. One of the distinguishing characteristics of this current cycle is that market participants immediately acknowledged that the economy would contract sharply. The specter of a near halt in economy activity catalyzed the government to launch numerous fiscal stimulus initiatives. Thus far, the federal government has appropriated \$6 trillion of fiscal stimulus, equal to 28% of the nation's annual economic outlook prior to the pandemic. As a result, we find ourselves amidst an intriguing economic experiment. There have been multiple examples of significant fiscal stimulus in the nation's history, but nothing approaching the scale of the four major legislative packages that have been enacted within the past year.

What we know about fiscal stimulus - whether spending increases, transfer payments, or tax cuts - is that it can raise economic output and incomes in the short-run by boosting overall demand. However, to have the greatest impact with the least amount of long-run cost, the stimulus should be timely, temporary, and targeted. The impact on Gross Domestic Product (GDP) of an incremental dollar of federal aid depends on how quickly the federal aid is disbursed. If fiscal stimulus is enacted too slowly, its ability to blunt a contraction in economic output and incomes is diminished. If, however, the fiscal stimulus is injected once the economic recovery has already firmly taken hold, then the economy is at risk of overheating and spurring inflation. If this were to occur, the central bank could potentially tighten monetary policy prematurely and truncate the economic expansion.

Economic data related to employment, manufacturing, and housing all suggest that an economic recovery has firmly taken hold. As a result, by the time the recent \$1.9 trillion stimulus works its way into circulation we will likely have already seen a surge in economic activity. This sequence almost ensures a meaningful rise in inflation readings. Part of this rise in inflation readings is due to what economists refer to as the "base effect," the distortions in the comparative monthly inflation figures because of abnormally low levels of inflation in the year-ago period. Federal Reserve Chairman Jerome Powell has been clear that he views any statistical uptick in inflation readings as "transitory." Therefore, the Federal Reserve currently does not plan on altering the central bank's very easy monetary posture. The clear message

being sent by the central bank is at odds with the “muscle memory” of capital markets, which have been conditioned over multiple economic cycles to anticipate and position for monetary tightening in advance of any action by the Federal Reserve.

As outlined by the Federal Reserve in August of last year, the central bank made a structural shift in its framework for managing money supply. The current Federal Reserve’s messaging around maintaining very easy monetary policy is consistent with this shift in framework, which allows inflation readings to be symmetrical around a 2% inflation target. The change implies that the central bank is comfortable with higher inflation. In the current environment, our concern is that the move back to full employment in the economy could happen much faster than the slow healing job market that followed the 2007 recession. As a significant portion of the population is inoculated, economic activity is likely to rebound sharply. Consumers have amassed nearly \$2 trillion in excess savings and have been aggressively reducing household debt. For example, consumer revolving credit, which consists primarily of credit cards, has fallen by \$132 billion since the peak in February of last year. Americans have less revolving credit debt today than they did in 2007, despite an economy that is 48% larger and has 30 million more people.

As the economy reaches full employment, and assuming inflation has reached 2% and is expected to keep climbing, then the Federal Reserve will likely be compelled to begin tightening monetary policy. This introduces the risk that the central bank believes it is too far behind the curve and begins briskly tightening monetary policy which could startle the capital markets. The risk of rising inflation expectations, an important input into the central bank’s mosaic, is especially noteworthy because the economy is already experiencing multi-year high prices in products such as lumber, copper, steel, shipping container rates, energy, cotton, corn, wheat, and used autos, just to name several. Lumber and plywood prices have risen close to 60% since the beginning of last year. Demand for construction material has accelerated due to cheap financing cost and new housing starts due to low inventory levels. The management of a large private plywood company recently shared with us that the company used to warehouse significant quantities of product to optimize mill production run-time. However, the demand pull has emptied the warehouses, and the mill is running at capacity. Now they are shipping directly to builders from the mill. Management teams are also starting to tell us that the skilled labor market is already tightening. We will continue to watch the labor market closely because the Federal Reserve has been clear that it is focused on the health of the labor market, but the labor market also holds the key to whether a durable inflationary pressure emerges in the economy. This is not our base case, but it bears close watch. Congress may also further stoke inflation if minimum wage legislation progresses.

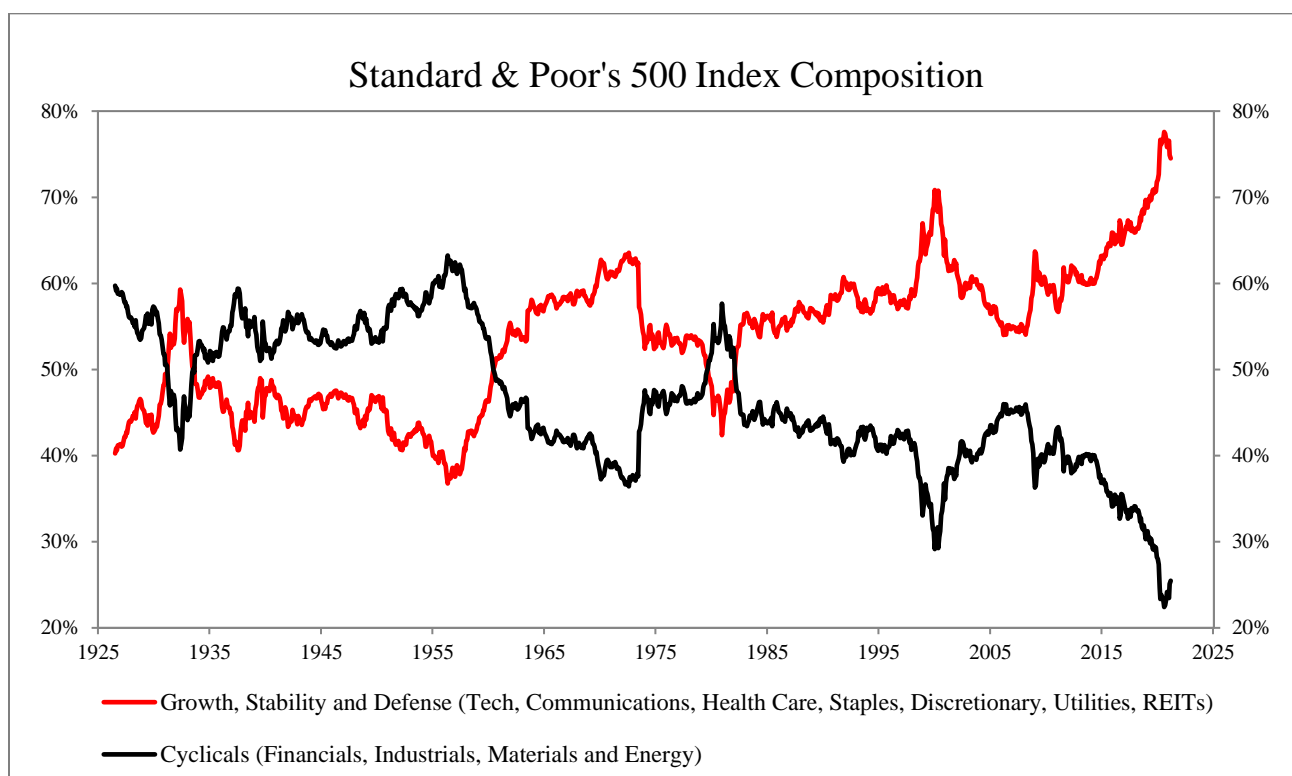
CAPITAL MARKETS

Capital markets have entered a “reflationary” period which is characterized by accelerating economic growth and rising inflation. When economies are in a reflation regime, there are often significant implications for capital market leadership. In general, reflation is good for commodities and equity values at the expense of bond prices and, in certain circumstances, the U.S. dollar. Equity markets typically tilt in favor of small companies over large, and investors seek shares of companies in the Energy, Financials, Materials, and Industrial sectors because they benefit from rising inflation and/or higher interest rates. Businesses in these four “cyclical” sectors of the economy are generally very sensitive to the business cycle, such that revenues generally are much higher in periods of economic prosperity and lower in periods of economic downturn. In essence, the volatility of their revenue growth is generally greater than that of non-cyclical sectors such as Technology, Communications, Health Care, Consumer Staples, Consumer Discretion, Utilities, and REITs.

The weightings of the eleven economic sectors fluctuate considerably over time as the fortunes of different segments of the economy rise and fall. Energy is one such example. The Energy sector represented 16.5% of the Standard & Poor’s 500 Index in July 2008 (and 29% in 1979 when LKCM opened for business), only to fall to 2.8% today. Reflecting record-breaking profits in 2008, ExxonMobil was the world’s most valuable publicly traded company every quarter of that year. Market indices must evolve over time to remain a relevant yardstick for the broader market and, to a lesser extent, the overall economy. As ExxonMobil’s market cap fell from over \$500 billion in 2008 to around \$175 billion last August, Dow Jones made the decision to replace ExxonMobil in favor of a software company, Salesforce.com, in the Dow Jones Industrial Average. The decision to reduce the index’s exposure to energy from two companies (Chevron and ExxonMobil) to one company reflected the substantially reduced market capitalization of the Energy sector relative to the broader market. This action ended ExxonMobil’s 92-year run as a constituent of the Dow Jones Industrial Average. A similar tale can be told about the weighting of the Financial sector within the Standard & Poor’s 500 Index, which reached a peak of 22.3% in December of 2006 prior to the Global Financial Crisis before falling to 11.3% currently. These data points also tell us how much more important information technology is in our lives.

The pandemic brought the longest economic expansion on record to a close, which was remarkable not only for its duration, but also for its tepid growth. It is little surprise that in a relatively placid economic backdrop with lackluster growth and little inflation that cyclical portions of the economy were outshined

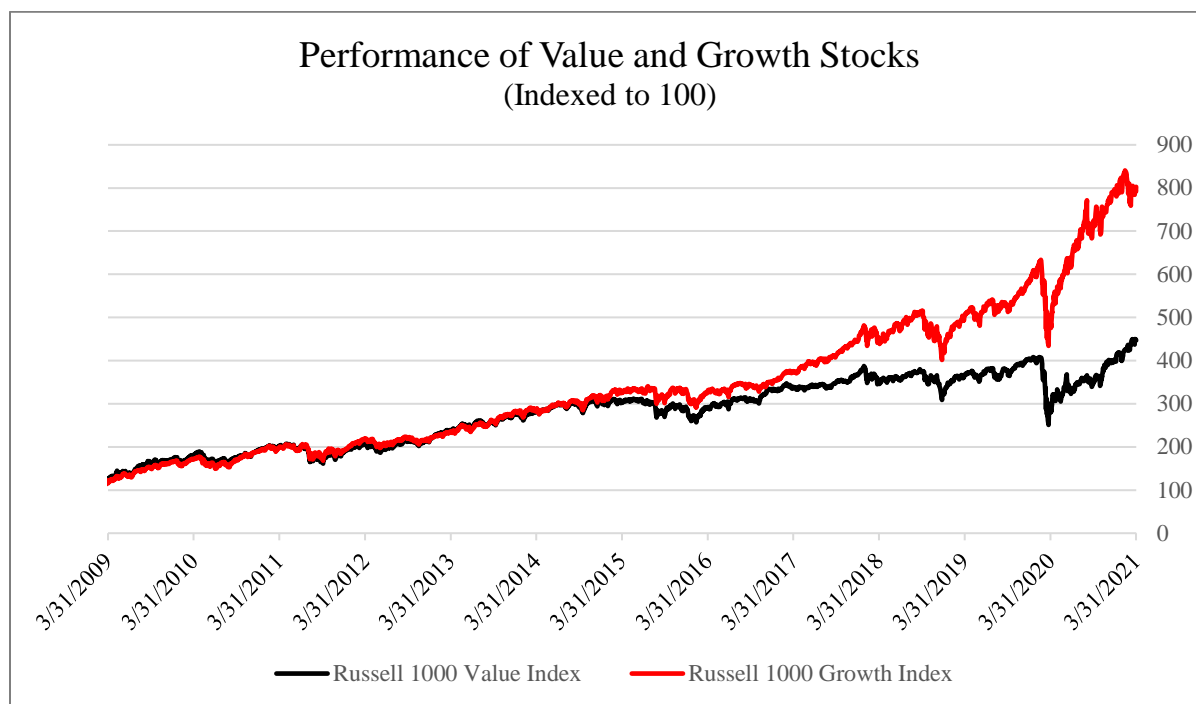
by growth areas - Technology, Communications, Health Care, and Consumer Discretion - in the last economic cycle. The chart below illustrates the stark contrast in the cumulative weighting of cyclical and non-cyclical sectors within the Standard & Poor's 500 Index. The pandemic accentuated the eroding market share of the cyclical sectors and depressed the weighting of the cyclical sectors within the Standard & Poor's 500 Index to a low of only 22.4% last August. Because of the wide divergence in index weightings, if investors sold a mere 1% of non-cyclicals and redeployed those dollars in the cyclical parts of the market, cyclicals would experience a 2.9% increase. Not surprisingly, the four best performing sectors in the first quarter were Energy, Financials, Industrials, and Materials. With the economy set to deliver the best economic growth in almost four decades this year, market leadership is reminiscent of the more volatile economic cycles prevalent in the 1950's through the 1980's when cyclical performance rose and fell sharply with a boom-and-bust economic rhythm.



Source: CSM, LKCM

Because the Price/Earnings ratios of cyclical sectors has been lower than for non-cyclical sectors such as Technology, Communication, or Health Care, the current market rotation in the first quarter can be described as investor preference for “value” over “growth,” a sharp reversal of the past several years. The chart on the following page illustrates the divergence between the cumulative performance of growth stocks and value stocks from the monthly bottom of the market low in the Global Financial Crisis in March 2009 through the end of the first quarter of this year. The relative performance of value versus growth

closed in the first quarter and may well narrow further as the year progresses as near-term earnings growth for value stocks is likely to outpace the earnings progression of growth stocks. We have never embraced this traditional dichotomy as an overarching investment thesis but it is interesting to observe.



Source: Bloomberg, LKCM

SUMMARY

Continued success in the domestic vaccine rollout should bolster an economic reawakening characterized by pent-up demand from consumers and businesses, both of which have ample liquidity. The significant amount of fiscal stimulus, which is still being injected into the economy, should spur economic growth to levels not seen in almost forty years. The recent back-up in long-term bond yields is understandable within the context of accelerating economic growth and higher near-term inflation readings. As long as bond yields do not rise enough to trigger a recession, which we view as very unlikely given the amount of fiscal support the economy is receiving, then we continue to remain constructive on equities.

A key unknown in our economic and capital markets outlook is the potential passage of the Biden administration's roughly \$2 trillion infrastructure package to be paid for by \$2 trillion in tax increases on U.S. corporations spread out over 15 years. Such levels of federal investment could crowd out investment by the state, local, and private sectors according to the Congressional Budget Office. Higher corporate tax rates raise the cost of capital for businesses. Aside from corporate taxes, there are a myriad of potential

tax changes to areas such as the top personal income tax rate, estate taxes, limiting federal deductibility of state and local taxes, and capital gains rates, among others. Investors will have to navigate any changes to existing tax laws and understand how legislative changes may impact consumer, investor, and corporate behavior.

FINANCIAL MARKET TOTAL RETURN*

	First Quarter 2021	Six Months Ending 03/31/21	One Year Ending 03/31/21	Annualized Return Two Years Ending 03/31/21	Annualized Return Three Years Ending 03/31/21	Annualized Return Five Years Ending 03/31/21
Standard & Poor's 500 Index	6.17%	19.07%	56.35%	20.60%	16.78%	16.29%
Russell 2000 Index	12.70%	48.05%	94.85%	21.70%	14.76%	16.35%
Value Line Composite Index	12.98%	40.98%	83.92%	11.74%	7.49%	9.29%
Dow Jones Industrial Average	8.29%	19.91%	53.78%	15.41%	13.61%	15.99%
NASDAQ (OTC) Composite	2.96%	19.09%	73.47%	32.17%	24.58%	23.50%
Bloomberg Barclays Capital Gov't/Credit Intermediate Bond Index	(1.86%)	(1.39%)	2.01%	4.42%	4.36%	2.75%

** Total Return Includes Income*

Michael C. Yeager, CFA
April 3, 2021

IMPORTANT INFORMATION

The commentary set forth herein represents the views of Luther King Capital Management and its investment professionals at the time indicated and is subject to change without notice. The commentary set forth herein was prepared by Luther King Capital Management based upon information that it believes to be reliable. Luther King Capital Management expressly disclaims any responsibility to update the commentary set forth herein for any events occurring after the date indicated herein or otherwise.

The commentary and other information set forth herein do not constitute an offer to sell, a solicitation to buy, or a recommendation for any security, nor do they constitute investment advice or an offer to provide investment advisory or other services by Luther King Capital Management. The commentary and other information contained herein shall not be construed as financial or investment advice on any matter set forth herein, and Luther King Capital Management expressly disclaims all liability in respect of any actions taken based on the commentary and information set forth herein.