LUTHER KING CAPITAL MANAGEMENT

SECOND QUARTER 2021 REVIEW

The current economic cycle has been turbocharged through a unique combination of market behaviors. First, policymakers reacted strongly to threats posed by the pandemic to households and businesses. These actions resulted in a 27% increase in the money supply since March of last year, and government engaged in significant deficit spending. Similarly, businesses curtailed operations, not to combat a normal economic downturn, but to survive an existential threat. These management decisions contributed to the largest ever quarterly decline in Gross Domestic Product (GDP), a rapid increase in joblessness, and extensive liquidation of inventory. Finally, households hoarded savings, establishing a new record level of savings to income, much of which currently remains in the form of personal savings. The combination of these actions resulted in GDP recovering to its prior peak after only a year, even though New York and California announced the lifting of all state-mandated restrictions only weeks ago. In contrast, it took three-and-a-half years for economic output to recover following the Global Financial Crisis, which ended in 2009.

The rapid pace of economic growth is accentuating supply and demand imbalances created by the recession, and the situation is compounded by the logistical and production challenges of smoothly restarting the global supply chain. This dynamic has given rise to labor shortages and rising inflation. More than half of this increase in the Consumer Price Index (CPI) in April and May resulted from higher vehicle prices, in tandem with a rebound in pandemic-affected service prices for flying and hotel accommodations. Input costs such as lumber, steel, and microchips have all recently peaked following a multifold increase. In terms of labor, aside from a few low-wage sectors such as retail and hospitality, overall wage growth remains constrained. On the surface, these data points thus far remain consistent with Federal Reserve Bank Chairman Jerome Powell's message that inflation will likely be "transitory." However, the degree to which inflationary pressures broaden and become persistent will have a significant impact on how investors view the likely path of monetary policy and corollary implications for the stock market.

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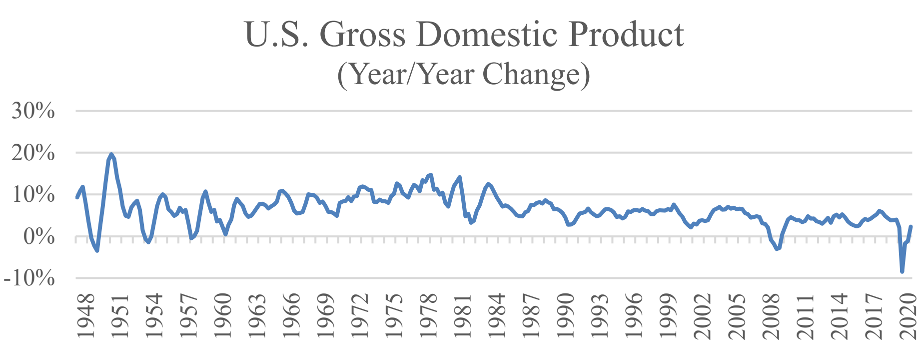
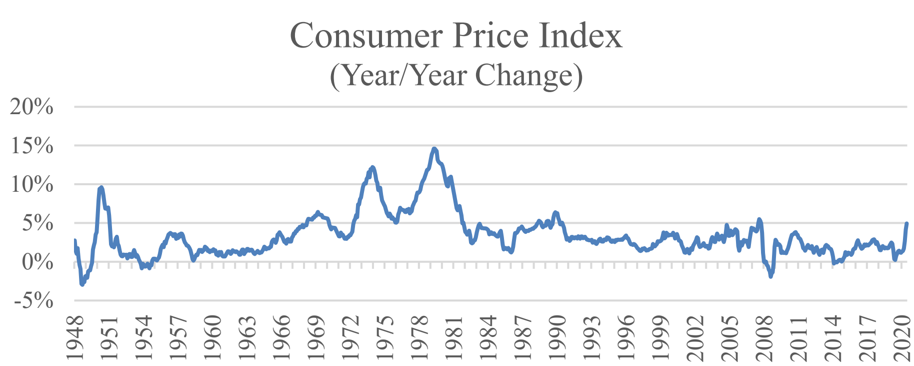
ECONOMY

With the economic recovery in full motion, investors face a much different set of questions versus last year. For example, how long will it take the economy to return to full employment, and what happens to inflation in the interim and beyond? There is a great deal of uncertainty and debate surrounding these two questions, as they are central to shaping the path of monetary policy, which remains extremely accommodative even as the economy begins to heat up. The analysis is unusually complex for three reasons. First, economic data are very volatile as year-over-year comparisons produce extreme outputs for series such as GDP and CPI, as illustrated in the following charts. Second, extraordinary fiscal and monetary policy, such as supplemental unemployment benefits and large-scale asset purchases by the central bank, continues to support the economy. However, it is unclear as to the degree to which readings of the economy's health are distorted. Third, both the demand side (how fast will consumer spending recover?) and the supply side (how much labor market slack is there and how quickly will it dissipate?) have been impacted, making the forecasting of a new equilibrium challenging. As a result, economic activity and data are likely to remain volatile and challenging to digest for investors.



Source: U.S. Bureau of Economic Analysis, LKCM



Source: U.S. Bureau of Economic Analysis, LKCM

Higher costs are returning as companies grapple with supply chain shortages and surging demand as the economy reopens. Inflation rose 5.0% in May compared to a year earlier, based on the latest CPI reading. However, a mix of temporary shortages, supply chain disruptions, and rebounds in transportation prices drove the spike in headline CPI. In our view, elevated inflation readings are likely to persist until markets resolve supply chain constraints and other post-pandemic disruptions. Therefore, we could see sustained higher inflation readings over the following several months and possibly into year-end. We believe it is important not to be overly dismissive of headline inflation. Market imbalances often emerge first in faster-moving prices such as gasoline, auto prices, hotel prices, and apparel, but can eventually creep into more moderate increases in a broader basket of slower-moving prices.

Beyond short-term price volatility in goods that are subject to dramatic swings in supply and demand, we continue to closely monitor the labor market for signs of wage pressure. The employment dynamic exiting the pandemic-induced recession is very different from what followed the 2007 – 2009 recession. At the conclusion of the previous recession, labor was plentiful relative to demand, which contributed to minimal inflation pressures. Abundant labor last cycle was also partly responsible for a decade of low productivity growth. In our view, there is a greater risk today that wage growth could rise at a faster pace than last cycle if current signs of labor market tightness prove more dogged than anticipated.

Regarding the labor market, there were 4.3% fewer people employed at the end of the second quarter than in January of last year, which implies meaningful slack resides in the labor market. However, company survey data, such as the National Federation of Independent Business (NFIB) small business survey, suggests a different story. The most recent survey indicated that 48% of firms reported difficulty filling vacant positions in May, the highest level in the 46-year history of the survey. The quick reopening-driven recovery in labor demand has tightened the labor market at a time when labor supply is still constrained by supplemental unemployment benefits and the lingering effects of social distancing. There were 9.5 million unemployed workers as of the end of June and 9.3 million job openings as of the last count. Therefore, the ratio of unemployed workers to job openings has fallen to a level usually associated with tight labor markets. This is particularly true in low-wage services that face greater competition from unemployment benefits. We are unlikely to get a clear view of the health of the labor market until this fall when supplemental unemployment benefits expire, and schools across the country open for in-person learning.

While investors rightly focus on inflation and the health of the labor market, there is another key aspect of the business cycle which we believe deserves attention – business investment, which is emerging as a powerful source of economic growth that will likely help sustain the economic recovery. Although business investment accounts for only around 18% of GDP, it carries important implications, because rising business investment helps fuel economic output. For example, if Starbucks builds a new store, Amazon purchases robots, or a company purchases Oracle software, these expenditures are counted as business investment. These types of expenditures are also important because they can lift worker productivity, or output per hour. While productivity was very sluggish during the prior economic expansion, capital goods orders are now beginning to show signs of growth, as indicated in the chart below. Business investment is also important because it drives job creation and can mitigate wage pressures.

Source: U.S. Census Bureau, LKCM

CAPITAL MARKETS

As we reach the midpoint of the year, equity prices have thus far posted good results. The Standard & Poor's 500 Index rallied 8.5% during the second quarter and returned 15.2% in the first half of the year, including dividends. Early in the second quarter, the technology-laden NASDAQ Composite Index had only posted roughly half of the return of the broader Standard & Poor's 500 Index for the year. This led to a string of headlines about whether this was the start of a long-awaited comeback for more economically sensitive cyclical stocks following a decade of value stocks lagging growth stocks. The reemergence of cyclical stocks was a rather logical conclusion, since cyclical stocks generally need stronger GDP growth to add more revenue (and earnings momentum), and they need some degree of inflation to support rising bond yields and a steep yield curve. This narrative largely held through the end of May, but then reversed significantly as bond yields fell and the Treasury yield curve flattened as investors attempted to reconcile two opposing forces. On one hand, the economy is growing much faster than consensus economic forecasts at the start of the year, which is a clear positive. However, too much of a good thing has ignited concerns that this growth will bring about higher inflation and therefore higher interest rates.

The difference between the 2-Year Treasury yield and the 10-Year Treasury yield fell by 0.36% in the second quarter, and the long end of the yield curve fell by 25 basis points while the short end rose. This was due to investors taking the Federal Reserve's recent meeting minutes to suggest that the central bank is soon to discuss tapering asset purchases as a first step to withdraw monetary support for the economy. One interpretation of the flattening yield curve is that the bond market is signaling the current level of economic growth is unsustainable and will soon revert into a steady state analogous to the pre-pandemic real growth rate of around 2.2%. The bond market is also potentially telegraphing the view that inflation, while perhaps a near-term concern, will dissipate in the more important intermediate term. Finally, the bond market may be reflecting the rising odds of a policy mistake by the Federal Reserve. The Federal Reserve has clearly communicated the recent adoption of a Flexible Average Inflation Targeting (FAIT) scheme. Under the new model, the central bank will presumably allow inflation to run above its 2.0% target. However, as inflation readings overshoot this target, investors are beginning to question the ability of policymakers to adhere to the new approach. While implementing extraordinary monetary policy is relatively easy, disengaging extraordinary monetary policy is much trickier.

CONCLUSION

Supply and demand imbalances have led to a spike in inflation readings; however, much of the underlying cause is directly linked to unique circumstances such as auto and travel prices, which we believe will moderate as year-end approaches. Turning to the labor market, while the pace of hiring has quickened, there is also a rational speed limit to which the matching of workers with employers can naturally occur. Pronounced labor market churn is due in part to the need for workers to change jobs to reach the marginal bid for new workers, which is around $15 per hour and may include a signing bonus. Excess savings and the ongoing unemployment top-up in many states give workers more bargaining power, while also allowing the unemployed to be more selective in finding the right match. However, these constraints should ease in the second half of the year as supplemental benefits expire and schools open for in-person learning. Our base case anticipates that the economy will lurch forward in 2021 with real growth likely between 8% and 10% for the year, in conjunction with strong corporate earnings. Accompanying inflation readings are anticipated to moderate by the end of the year.

We believe there are two prominent risks to our outlook. The first is a pandemic resurgence sparked by the spread of more powerful virus variants against which existing vaccines are substantially less effective. Such a development would likely negatively impact global economies more substantially than the domestic economy due to differences in vaccination levels and health care infrastructure. Under this scenario, global supply and demand imbalances would persist, rather than correcting. The second key risk is that strong inflation readings in a narrow set of goods and services bleeds over into a broader basket of goods and services. If the seemingly tight labor market constricts further and wage growth is not offset by productivity improvements, further cost pressures could build in the economy. As a result, the Federal Reserve Bank could conclude it is behind the curve and move quickly to tighten monetary policy to dampen inflation. Such an action could startle capital markets. Neither of these more visible risks should be overlooked, but our base case anticipates economic momentum to carry over into next year and monetary policy to tighten very slowly, both of which continue to create an economic backdrop that is supportive of equity values.

*FINANCIAL MARKET TOTAL RETURN**

	Second Quarter 2021	**Six Months Ending 06/30/21**	**One Year Ending 06/30/21**	**Annualized Return Two Years Ending 06/30/21**	**Annualized Return Three Years Ending 06/30/21**	**Annualized Return Five Years Ending 06/30/21**
Standard & Poor's 500 Index	8.55%	15.25%	40.79%	23.03%	18.67%	17.65%
Russell 2000 Index	4.29%	17.54%	62.03%	23.00%	13.52%	16.47%
Value Line Composite Index	5.94%	19.69%	55.29%	14.69%	7.91%	10.17%
Dow Jones Industrial Average	5.08%	13.78%	36.34%	16.45%	15.02%	16.66%
NASDAQ (OTC) Composite	9.68%	12.92%	45.29%	35.69%	25.73%	25.85%
Bloomberg Barclays Capital Gov't/Credit Intermediate Bond Index	0.98%	(0.90%)	0.20%	3.60%	4.70%	2.63%

** Total Return Includes Income*

Michael C. Yeager, CFA
July 3, 2021

IMPORTANT INFORMATION

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