

LUTHER KING CAPITAL MANAGEMENT

THIRD QUARTER 2021 REVIEW

Rather than being in the thirteenth year of an economic expansion, the U.S. economy is in the seventeenth month of a new economic cycle following the shortest recession in U.S. history – lasting only two months. In response to the pandemic, the federal government has spent an incremental \$5 trillion above what would likely have been spent had the prior economic expansion been uninterrupted. The incremental \$5 trillion of federal spending in an economy that generated \$20.9 trillion of goods and services in 2020 largely achieved the goal of mitigating the economic fallout created by the pandemic. For example, government transfer payments lifted personal incomes to higher levels post-pandemic than pre-pandemic. However, the impact of injecting an amount of stimulus equal to nearly a quarter the size of our national economic output is still reverberating through the economy.

It is appropriate that fiscal and monetary policy should begin to revert to a less prominent role in the economy. This scaling back of support for the economy is occurring at a time when the rate of economic growth is slowing from a very high level. Inflation readings, meanwhile, have been rising. As a result, headlines of “stagflation” have recently emerged. Some amount of inflation should have been anticipated as consumer incomes surged at a time when the production of goods was curtailed. This dynamic led to large supply and demand imbalances which dramatically pushed the cost of some goods, such as autos and housing, much higher. Energy prices are also a part of the inflation discussion as the price of a barrel of West Texas Intermediate crude rose 54.6% through the first three quarters of the year. Finally, the August jobs report showed continued upward pressure on wages with fewer workers returning to the labor force than expected.

Stagflation headlines, far from our base case for 2022, and recent financial stress at the world’s most indebted developer and biggest issuer of noninvestment grade bonds in Asia, Evergrande, contributed to a market decline in the final month of the quarter. The Standard & Poor’s 500 Index declined 5.1% peak-to-trough in September, marking the first correction of greater than 5.0% since November 2020.

ECONOMY

The economy is anticipated to expand around 6.0% this year before inflation. The Delta variant has been disruptive to the pace of expansion and is a reminder of the downside risk COVID continues to pose to forecasts. The emergence of the Delta variant limited the acceleration of consumer spending on services that had been anticipated to offset declining fiscal support of the consumer in the second half of this year. This decline was evident in the recently released August retail sales data which was not much changed from June. How, when, and if consumers decide to spend their estimated \$2.4 trillion of excess savings (equal to about 15% of annual consumption) will have a significant impact on the trajectory of the economic expansion.

The fall-off in aggregate demand which impacted the economy early last year is no longer the primary economic challenge. It has instead been replaced by supply challenges. Rigid supply chains, spiking transportation costs, and lack of available workers have conspired to raise the costs of many items. Firms are indicating that these issues are likely to persist well into next year. From an economic growth perspective, the central question is not when things normalize, but when do things stop getting worse. It is possible that we are currently, or very near, the peak in supply chain disruptions. However, we are likely several calendar quarters away from a return to normalization.

Inventories, which include raw materials, works in progress, and finished goods, declined by a record \$289.9 billion during the second quarter of last year. Production needs to increase to meet the strong level of demand and replenish inventories. Some auto manufacturing plants are running twenty-four hour shifts six days a week in an effort to satiate demand assuming they have an adequate supply of semiconductor chips, an essential component of modern vehicles. To ramp production, firms must invest in new plant and equipment or add additional shifts. A similar dynamic occurred on a smaller scale in the economy in 2018-19. At that time, business investment never fully materialized as the trade war caused firms to delay investment decisions. Today, however, new orders for capital goods are booming which has positive implications for future productivity improvement.

Central banks may welcome moderate upward pressure on inflation for several reasons. First, it makes reaching inflation targets achievable which has been a challenge over the past decade, including domestically. Second, higher inflation means that the recent increase in sovereign debt weighs less heavily on economies in real terms. Finally, central banks need the latitude afforded by inflation pressure to

increase interest rates which will position central banks to address future economic slowdowns by lowering interest rates.

It is widely anticipated that the Federal Reserve will announce its intent to begin tapering the monthly amount of bond purchases at its November meeting. The importance of this news is not necessarily the gradual reduction in bond purchases. Rather, quantitative easing has become a signal that the central bank will take every action necessary to prevent a financial crisis or economic calamity. This, in turn, boosts investor confidence about the economic future which sends bond prices lower, and bond yields higher. Investors now view periods of quantitative easing as the central bank creating a safe harbor in which taking equity risk is favorable. Just as importantly, monetary tightening has become a two-step process under quantitative easing. Investors should expect the Federal Reserve to first announce its intention to reduce the current pace of bond purchases, followed by a gradual step-down in monthly purchase volumes, often referred to as “tapering.” Only then does the visibility of an increase in the Federal Funds rate become more apparent.

CAPITAL MARKETS

Price spikes in the energy markets are one source of inflation concern among investors, especially as seasonal demand may further strain energy supplies. The adage that “the cure for high commodity prices, is high commodity prices,” has yet to stifle upward price pressure because of the growing inelasticity of supply. Domestic crude oil production has been the non-OPEC “swing producer” since 2009, but there has been an unprecedented slowdown in drilling activity. The last time oil prices were at the same level as today was October 2018 when the number of drilling rigs operating in the U.S. was twice the number operating today. Energy producers have, thus far, held close to their capital discipline strategies. The Energy sector was the best performing sector within the Standard & Poor’s 500 Index through the first three quarters of 2021, largely driven by higher commodity prices.

Falling COVID case counts, sticky inflation, the looming debt ceiling, and a more hawkish Federal Reserve combined to exert upward pressure on bond yields in September. The current price action in the bond market is reminiscent of the first quarter as yields rose in response to the economic reopening. The sharp rise in long-term bond yields this year has benefitted the Financial sector which was the second best performing area of the market behind Energy during the quarter.

We estimate that corporate profits will expand approximately 50% during 2021 given the pandemic induced pressure on earnings in 2020. With corporate earnings growing by more than the market return this year, the market valuation in terms of the Price/Earnings ratio has compressed slightly this year to 21.2X estimated 2021 earnings. As we look forward into 2022, we anticipate corporate earnings will expand close to 10% prior to any necessary adjustment for potentially higher corporate tax rates. If the corporate tax rate were to rise to 25% from 20% currently, we estimate that corporate earnings growth would be closer to 5.0% in 2022.

With corporate and government debt relative to gross domestic product at all-time highs, the economy is extremely sensitive to potential interest rate movements. With the Federal Reserve likely to announce its intent to begin tapering bond purchases at its November policy meeting against a backdrop of soaring energy prices and upward pressure on wages, interest rates have become a primary focus for investors. A return to a 1970's style rampant inflation is not likely in our view. Fifty years ago, policy complacency was accompanied by a formidable combination of strong labor unions, buoyant commodity prices, high tax rates, and poor corporate productivity, which embedded inflation expectations on the part of both business managers and workers.

CONCLUSION

Just as the two-month recession last year was unlike any previous recession in terms of steepness and brevity, the new business cycle is unique as well. The economy will likely expand 6.0% in real terms this year and the Federal Reserve forecasts well above trend growth of 3.8% next year. Economic growth will continue to be a tailwind for corporate revenue growth. We continue to expect exceptional economic growth this year and strong gains in 2022. This economic recovery is front-end loaded due to significant fiscal support, unlike the last couple of long-lasting cycles.

The lingering effects from the record amount of fiscal stimulus and continued reopening of the services part of the economy will provide sufficient tailwinds to grow the economy above its long-term trend next year. This, in turn, is supportive of growth in corporate profits which are a meaningful driver for the direction of equity prices, assuming no significant rise in interest rates. The rate of corporate profit growth could prove less than anticipated if corporations face a higher federal income tax rate. In addition, the recent strength in the U.S. dollar is a headwind to multinational companies that must translate earnings abroad back into U.S. dollars.

As a result of these uncertainties, we anticipate market volatility will likely be greater in the coming twelve months than the previous twelve months, which has been well below historical levels. Risks to our outlook must begin with COVID, as the Delta variant has reminded us of this year. Beyond the pandemic, transitioning the economy to stand on its own again without major fiscal and monetary support has the potential to be a bumpy process. The outlook for this transition is currently clouded by higher than comfortable inflation readings. We continue to welcome some level of inflation; however, we believe wages and shelter pose the potential for inflation to be more persistent than the Federal Reserve likely anticipated.

FINANCIAL MARKET TOTAL RETURN*

	Third Quarter 2021	Nine Months Ending 09/30/21	One Year Ending 09/30/21	Annualized Return Two Years Ending 09/30/21	Annualized Return Three Years Ending 09/30/21	Annualized Return Five Years Ending 09/30/21
Standard & Poor's 500 Index	0.58%	15.92%	30.00%	22.35%	15.99%	16.90%
Russell 2000 Index	(4.36%)	12.41%	47.68%	21.76%	10.54%	13.45%
Value Line Composite Index	(3.78%)	15.16%	43.70%	13.57%	5.54%	8.07%
Dow Jones Industrial Average	(1.46%)	12.12%	24.15%	14.56%	11.00%	15.68%
NASDAQ (OTC) Composite	(0.22%)	12.67%	30.33%	35.53%	22.66%	23.42%
Bloomberg Gov't/Credit Intermediate Bond Index	0.02%	(0.87%)	(0.40%)	2.91%	4.63%	2.60%

** Total Return Includes Income*

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October 9, 2021

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